REVIEW OF THE FEDERAL AGRICULTURAL MORTGAGE CORPORATION [FARMER MAC]

HEARING

BEFORE THE

SUBCOMMITTEE ON CONSERVATION, CREDIT, AND RURAL DEVELOPMENT

OF THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIRST CONGRESS

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REVIEW OF THE FEDERAL AGRICULTURAL MORTGAGE CORPORATION [FARMER MAC]

WEDNESDAY, SEPTEMBER 27, 1989

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CONSERVATION,
CREDIT, AND RURAL DEVELOPMENT,
COMMITTEE ON AGRICULTURE,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:10 a.m., in room 1302, Longworth House Office Building, Hon. Glenn English (chairman of the subcommittee) presiding.

Present: Representatives Penny, Stallings, Nagle, Staggers, Long, Coleman, Morrison, Gunderson, and Holloway.

Staff present: Fred J. Clark, associate counsel; John E. Hogan, minority counsel; Alice Devine, minority associate counsel; Glenda L. Temple, clerk; Bill Cherry, James E. McDonald, James R. Lyons, James A. Davis, and David Ebersole.

OPENING STATEMENT OF HON. GLENN ENGLISH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OKLAHOMA

Mr. ENGLISH. The subcommittee will come to order.

The Agriculture Credit Act of 1987 created a new secondary market for agricultural land loans, the Federal Agricultural Mortgage Corporation which we have come to call Farmer Mac. The statute allows the Congress a 90-day period to review the underwriting standards issued by Farmer Mac. Today's oversight hearing focuses primarily on those standards which were issued on June 30, 1987.

We will also have an opportunity to view those standards in context with the pooler and diversification standards that were issued at about the same time. Together, these standards present a picture of how Farmer Mac plans to conduct its business.

Farmer Mac was created to provide additional sources of long-term loans for the American family farmer. Although Farmer Mac was patterned somewhat on the successful secondary markets for residential loans, we do not yet know if pools of loans can be gathered or if the securities to be issued against those pools will be attractive to the investors.

We will be interested in hearing the views of various witnesses on the eventual success of Farmer Mac.

Mr. Coleman.

OPENING STATEMENT OF HON. E. THOMAS COLEMAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

Mr. COLEMAN. Mr. Chairman, we want this program to work and whatever it takes to make it work, that's what we want to hear today. If there are any impediments by Government agencies or regulatory bodies, we certainly ought to be able to get those on the table today and try to resolve these issues that may be slowing down the actual capability of this agency that we have created in this program. I look forward to trying to get into that day.

Thank you, Mr. Chairman.

Mr. ENGLISH. Thank you very much.

Prepared statements from other members will be placed in the record, at the point.

[The statement of Mr. Stallings follows:]

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COMMITTEE ON AGRICULTURE
COMMITTEE ON SCIENCE, SPACE AND TECHNOLOGY
SELECT COMMITTEE ON AGING

Congress of the United States
House of Representatives
Washington, DC 20515

OPENING STATEMENT
CONSERVATION, CREDIT, AND RURAL DEVELOPMENT
HEARING ON FEDERAL AGRICULTURAL MORTGAGE CORPORATION
September 27, 1989

HONORABLE RICHARD H. STALLINGS

Mr. Chairman. As we begin debate on the 1990 Farm Bill, I believe it is appropriate that one of the starting points be a Subcommittee review of the initiation of the secondary market for agricultural loans. As an initial sponsor of the Farmer Mac legislation, I have had much interest in this area.

The Federal Agricultural Mortgage Corporation -- Farmer Mac -- was created by the Agricultural Credit Act of 1987. The need for which this program was created, to provide a stable secondary market for agriculture loans, still remains. I am optimistic, however, that by the end of the year we will have the first pool of loans. I am eager to hear the witnesses' testimony, and hope that through our work we attract new capital to assist in the financing of agricultural real estate and provide a new source of liquidity for farm credit originators.

Farming has evolved from its labor intensive origins to a stage where capital, or lack of it, makes many of the fundamental decisions for farmers. The potential of the new market is enormous. Participants include loan originators, loan poolers, Farmer Mac and individual investors. The initial stock offering of $20 million was so attractive that it was tempting to extend the offering. Over 1500 rural banks bought enough stock to qualify as loan poolers.

At this time last year, $65.7 billion of farm debt was outstanding. Of this amount, 47 percent was originated by the Farm Credit System, 23 percent by commercial banks, 15 percent by Farmers Home Administration, and 14 percent by life insurance companies. Loan poolers will use the loans originated by these lenders as collateral against which Farmer Mac will issues registered securities to the public.

Mr. Chairman, small rural banks make up the heart of Farmer Mac and their continued participation is essential to its success. I am eager to be reassured that the local banks can maintain their role as servicers, rather than ending up as a local point of contact only. Further, procedures must be worked out whereby the sold portion of a Farmer Mac loan will not apply against the bank's lending limit.

The underwriting standards used by the secondary market will require broad understanding and wide acceptance to have a successful market. The program must provide incentive to the loan originators, and care must be taken to ensure the risks and costs do not outweigh the benefits for financial institutions. Also, a lender's flexibility to work with a financially troubled farmer must not be reduced by participation in Farmer Mac.

I am interested in hearing from representatives of all segments of the new secondary market, and look forward to today's hearing. By the way Mr. Chairman, last weekend I was having a discussion with an Idaho farmer, and I asked him what he thought of my speech on the agriculture problem. He told me he thought it wasn't bad, but a good days rain would do a lot more. Thank you, Mr. Chairman for your efforts, and for holding this hearing today.

Mr. ENGLISH. Our first witness today will be Mr. Henry D. Edelman, who is the President and Chief Executive Officer of the Federal Agricultural Mortgage Corporation or Farmer Mac.

Mr. Edelman will be accompanied by Mr. Jack Dahl, Chairman of the Farmer Mac. Mr. Edelman, you might also for the record want to introduce the other gentlemen who are accompanying you to the witness table.

Mr. EDELMAN. Actually, I'm going to let Mr. Dahl lead off, if I may.

Mr. ENGLISH. OK. Fine.

Would you introduce the other gentlemen with you, Mr. Dahl, who are also accompanying you to the witness table?

Mr. DAHL. Yes. I will introduce them.

STATEMENT OF JACK DAHL, CHAIRMAN OF THE BOARD, FEDERAL AGRICULTURAL MORTGAGE CORPORATION, ACCOMPANIED BY KEN GRAFF, PRESIDENT, CENTRAL COAST FARM CREDIT SERVICES OF CALIFORNIA; TOM OLSON, PRESIDENT, LISCO STATE BANK, LISCO, NE; AND FRANK SCHAFER, SPRINGFIELD FARM CREDIT DISTRICT

Mr. DAHL. Good morning, Mr. Chairman, members of the subcommittee. My name is Jack Dahl and I am currently the Chairman of the Board of Farmer Mac. I am a cattleman from North Dakota. I've been a cattleman all of my life. During 1987, when the agricultural credit legislation was in Congress, I was president of NCA. The National Cattlemen's Association, along with many other commodity groups and general farm organizations, lobbied very strongly for the passage of that act and the creation of Farmer Mac. I believe very strongly that the need for Farmer Mac is as great today as it was at that point in time, and that it will add a great deal to the long-term predictability and stability in agricultural lending. We intend to accomplish that. We also intend to carry out the intent of Congress while doing that.

I am pleased this morning to be able to introduce some of the other Board members who are with us this morning. From our Board of Directors, the Chairman of two of the task forces that were appointed to develop the standards that you are presently reviewing. On my left is Mr. Ken Graff, who is president of the Central Coast Farm Credit Services in California. Mr. Graff was chairman of the diversification standards task force. Second, on my right, is Mr. Tom Olson. Tom is the president of the Lisco State Bank in Lisco, Nebraska. Tom was chairman of the appraisal standards task force. Not able to be with us today is another of our directors, Mr. Jim Pearson, who is the president and CEO of the Springfield Farm Credit District. Jim was the chairman of the underwriting standards task force. Standing in for him today is Mr. Frank Schafer, who is third on my right. Mr. Schafer was a member of the underwriting standards task force and he is also the senior vice president for credit from the Springfield Farm Credit District.

I would like to speak very briefly, Mr. Chairman, on a bit of the history of Farmer Mac and give you some of our progress to date. The interim board, which was appointed by President Reagan in

May 1988, completed its major task—the sale of Farmer Mac's common stock—in November 1988. The stock sale in turn created stock holders who were then able to elect the permanent board of directors in March 1989. As required by the act, Farmer Mac submitted its credit underwriting, loan repayment, and security appraisal standards to Congress and established eligibility standards for certified facilities commonly known as poolers on June 30, 1989. Farmer Mac's loan diversification standards were submitted to Congress on July 18, 1989.

We now look forward to the completion of your congressional review and to Farmer Mac becoming fully operational.

Mr. Chairman, I would like now to introduce Mr. Henry Edelman, President and CEO of Farmer Mac, who will give our testimony this morning.

Thank you very much.

STATEMENT OF HENRY D. EDELMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FEDERAL AGRICULTURAL MORTGAGE CORPORATION

Mr. EDELMAN. Thank you, Jack.

Mr. Chairman, distinguished members of the subcommittee. My name is Henry Edelman and I am the President and Chief Executive Officer of Farmer Mac. It is a pleasure to appear before your subcommittee to discuss the financial means by which Farmer Mac expects to deliver the benefits Congress intended for the farmers and ranchers of this Nation. I've also submitted a detailed written statement for the record that I don't intend to read today.

The subcommittee played an important role in crafting the Agricultural Credit Act of 1987. You determined that more efficient financing of loans for agricultural real estate and rural housing would be essential to the resolution of the agricultural credit crisis of the mid-1980's. Farmers and ranchers who are running sound businesses need and deserve the availability of long-term credit at stable interest rates from lenders with greater liquidity and lending capacity, as intended by the act. Access to this type of credit can be achieved most efficiently through the capital market.

With sound credit underwriting, loan repayment, security appraisal, and diversification standards in place, Farmer Mac will be able to deliver to agricultural and rural housing borrowers the benefits the capital markets have for so many years provided to urban residential borrowers. Farmer Mac must and will provide benefits to a wide range of financially sound agricultural producers and rural homeowners without exposing the Government to significant risk. Through Farmer Mac these borrowers will gain immediate access to new sources of long-term credit and an increasingly efficient and competitive lending environment. At the same time, community banks and other lenders will gain increased liquidity and an opportunity to spread interest rate and credit risks. It will be in the mutual interest of all those involved in the Farmer Mac Program to perpetuate existing customer relationships. This will be the best way to minimize losses and maximize the performance of the program. In addition, it is important that poolers be fair and

reasonable in the relationships they establish with originators and Farmer Mac is going to oversee that process.

I would like to talk a little bit about the direction in which Farmer Mac is headed. As constituted by the act, Farmer Mac represents an important innovation in the pattern of existing Government-sponsored enterprises. Yet, it will be engaged in a line of business familiar to the private sector capital markets. Functionally, Farmer Mac will resemble a group of specialized participants in the capital markets—the mono-line bond insurers. We're structuring Farmer Mac's operations accordingly. This means that before Farmer Mac places its guarantee on any pool of loans, it will not only confirm that the loans meet various standards, but also perform a dynamic risk analysis of the pool.

Eligible borrowers will obtain loans from originators—that is the banks that hold the requisite amount of Farmer Mac stock. Originators must underwrite the borrowers' credit and appraise the real estate pursuant to Farmer Mac standards. Originators will shop among competing poolers for the best terms of sale for qualified loans.

The inclusion of rural housing loans in the Farmer Mac Program could provide significant home financing benefits in small communities across the Nation. We have taken advantage of the experience of the Federal National Mortgage Association by adopting most of its underwriting standards but we have eliminated those standards that normally preclude rural housing loans.

Farmer Mac will guarantee timely payment of principal and interest on securities that represent no more than the most reliable 90 percent of the loan payments generated by pools of qualified loans. The pools must be composed of loans that meet Farmer Mac's standards.

Farmer Mac's financial integrity will be supported by several things—the reserve and subordination requirements established for each pool, which will depend upon the pool and security characteristics; initial and annual guarantee fees; Farmer Mac's own loss reserves, equity, and retained earnings, and ultimately Farmer Mac may issue up to $1.5 billion debt to the U.S. Treasury to fulfill its guarantee obligations. I can't emphasize this enough, we have designed the program so that Farmer Mac should never have to draw upon the line to Treasury.

Consistent with the act, Farmer Mac developed market-driven underwriting, loan repayment, appraisal, and diversification standards. We worked with experts from a variety of Farmer Mac constituent groups including community banks, large commercial banks, insurance companies, the Farm Credit System, commodity and farm groups, professional associations, Government agencies, and the public. Following the submission of the standards to Congress, we addressed and satisfied concerns raised by the Independent Bankers Association of America by clarifying the interpretation and intent of certain provisions of the standards.

Farmer Mac's credit underwriting standards were formulated to reflect the general profile of the sound borrower. The credit underwriting standard No. 9 was added to permit flexibility to include other demonstrably sound borrower profiles. Under that standard, nonconforming loans must consistently exceed one or more of the

standards to which they do conform and they must be made to producers of particular agricultural commodities or products for whom such a credit profile would typify a sound borrower. Farmer Mac will require that this be convincingly demonstrated, most likely by reference to a record of historically high quality loans to borrowers who meet the proposed commodity-specific profile.

We've heard some concerns that this particular standard was an invitation for changing any standard. We don't see it that way at all. We recognize that we cannot set one group of standards that would be uniform for all of agriculture, but rather we can set one basic group of standards and then recognize that different types of agriculture will require modifications to that and that those have to be carefully considered. That's our intent in No. 9. Considered as a group, the standards make provisions for a broad-range of agricultural borrowers to qualify for financing under the Farmer Mac Program regardless of the commodity they produce.

For geographic diversification within the pools, Farmer Mac looked first to the USDA regions for growing conditions—there are 10 regions—including weather and other natural risks but permitted a choice of three regions to facilitate competition among poolers. We included a warning against too narrow compliance. There had been some concerns there might be a technical evasion of diversification and we're intending not to permit that but at the same time to permit pooling within just three regions where it is sufficiently diversified.

For commodity diversification, commodity groupings were chosen for statistically verified economic independence. We tried to avoid grouping commodities in such a way that the groups would be cyclical with each other. We're very confident that they move independently.

Farmer Mac's standards work cumulatively and interactively to produce pools that should result in ultimate losses of less than 10 percent in worst case economic scenarios. We recognize that no single standard can be relied upon as a meaningful measure of credit quality, weak or strong. What we really intended here was not to set up—I use some track and field analogies—not to set up a pole vaulting challenge to borrowers, can they get over these hurdles one by one; but rather a broad jump—that is, not setting any one standard as the real screen but setting a group of standards to act as a cumulative screen so that a good borrower should be able to clear a group of reasonable standards and become eligible for the program.

The legislative history of the act makes it clear that the intent of Congress was that Farmer Mac should undertake its secondary market responsibilities in the most efficient manner. In determining the most effective method for providing its guarantee to pools of qualified loans, Farmer Mac is following the practices of the other secondary market agencies which have a proven track record. Farmer Mac will rely upon the underwriting appraisal and diversification standards only as a first screen. We will examine each pool in its totality to determine that the senior securities guaranteed by Farmer Mac are adequately protected.

We have heard concerns expressed to the effect that our standards might not be sufficient in every instance. Again, those com-

ments appear to be based on the assumption that we will perform only static evaluations of pools—that is, we'd only look at the loans one by one and guarantee pools where each loan passes a set of standards. This led us early on to the conclusion that regardless of the standards we set further analysis of each pool was going to be necessary to ensure that potential losses in an economic stress situation would not exceed the level subordination or reserves supporting each pool. We have worked in conjunction with experts from an independent public accounting firm to use industry standard computerized-risk analysis techniques used by bond insurers. Using that kind of a dynamic evaluation approach, Farmer Mac has the right to reject a pool, to require restructuring of a pool, or to require greater than 10 percent reserves or subordination for a pool that is economically weak, even though its loans comply with all of our standards. So this is a two-step process. First, being sure that the loans in a pool conform to our standards, and then, second, satisfying ourselves that the structure of the security and the quality of the loans together is going to be sufficient to withstand a severe economic downturn with an outcome that Farmer Mac would not have to go beyond its guarantee fee income to make necessary guarantee payments.

Participants who work in the capital markets with the rating agencies and the bond insurers have long accepted this approach to the evaluation of pools of loans. We have applied the same computerized-risk analysis techniques to test and prove the validity and reliability of our standards by using them as a primary screening device for actual agricultural loan data from the last 25 years. The detailed analysis we made on that basis has demonstrated to us that loans conforming to our standards, used as collateral through the issuance of Farmer Mac guaranteed senior securities, supported by a 10 percent subordinated interest should result in no guarantee payments by Farmer Mac in excess of guarantee fees received. So, what we've done here is verified that, based on historical data, the standards we set would consistently work in an economic downturn as long as there was 10 percent subordinated or reserve supporting them.

The treatment of the retention of a Farmer Mac subordinated interest in connection with the sale of loans into a pool as a sale of assets with recourse under risk-based capital guidelines promulgated by the Office of the Comptroller of the Currency is an issue of tremendous importance to Farmer Mac. This is really the most serious obstacle in Farmer Mac's path right now. The position taken by OCC to date would place Farmer Mac in an inequitable position relative to the treatment already accorded to Fannie Mae for housing programs that are functionally equivalent to Farmer Mac. The failure of OCC to apply its current regulations in a manner consistent with its treatment of Fannie Mae will significantly limit the participation of national banks in the Farmer Mac program both as originators and poolers. If and when OCC modifies the rules applicable to Fannie Mae, it is expected that Farmer Mac's program would necessarily have to conform. However, Farmer Mac's current competitiveness in the capital market is contingent on receiving a favorable response from OCC now.

Another regulatory issue of great importance to Farmer Mac is Treasury's determination regarding the eligibility of Farmer Mac guaranteed securities for the so-called book entry system of the Federal Reserve System. However, despite some very strong congressional support on this matter—which we greatly appreciate—Treasury has failed to respond to our request.

In addition, SEC registration procedures for Farmer Mac guaranteed securities will create additional costs for our program and its beneficiaries if we're unable to obtain adequately expedited treatment of SEC filings by poolers.

In summary, on the regulatory front, we're looking at some problems. Some problems are more serious than the others, but we need to resolve all of them if Farmer Mac is going to work optimally.

We believe we've accomplished a great deal in the year since Farmer Mac's interim board first met. The Board of Directors and management are pledged to make the secondary markets for agricultural real estate loans and rural housing loans successful. We appreciate your interest and thank you for the opportunity you have provided us to make this statement in the hearing today.

[The prepared statement of Mr. Edelman appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you very much Mr. Edelman. I appreciate your testimony. Let me say that without objection all of Mr. Edelman's written testimony and all the written testimony of all of our witnesses will be made a part of the record. I hope our other witnesses will feel free to summarize their testimony as well.

Mr. Edelman, as the situation stands right now, when do you anticipate the first pool will take place under Farmer Mac?

Mr. EDELMAN. We would like to think that would be before the end of the year. If we could just talk about the timetable for a moment. We're expecting that we will issue our securities guide by the end of October or early November, shortly after the congressional review period is concluded. After people have had an opportunity to look at the guide and we have certified facilities to act as poolers, we're expecting to see some pools coming in before the end of the year.

Mr. ENGLISH. This is probably a little bit unfair but this subcommittee is focusing a good deal of attention these days on the subject of rural development and I note that within the jurisdiction of Farmer Mac we have the possibility of pooling taking place with regard to rural housing. Housing, of course, plays a very important role in rural development. In some ways, I would think that particular portion would be the easiest given the experience that you could draw on from other pooling that has taken place in housing in urban areas. There is quite a history on that. Would that be correct?

Mr. EDELMAN. I think that it would be easy but at the same time there are a lot of qualifications on that because there are people who want to see a track record for rural housing, which is not going to be a lot easier than a track record for agricultural real estate.

Mr. ENGLISH. But as far as implementing and setting up a pool for rural housing, given the experience that you have with other agencies, it wouldn't be that difficult. Is that correct?

Mr. EDELMAN. I'd like to think so, yes.

Mr. ENGLISH. Obviously, given the 2,500 limit that is set within the legislation, if, in fact, we're going to be looking at rural communities—I think generally speaking the Farmers Home Administration considers a rural community anything under 20,000. What would be your feeling with regard to expanding the population limitation that is contained in the existing law?

Mr. EDELMAN. We would have no problem with that.

Mr. ENGLISH. Would you anticipate given your other responsibilities, given the first pool that will be coming up toward the end of this year, given the experience of other agencies in this area, would you have any difficulty in setting up a pool for rural housing sometime let's say in early 1991?

Mr. EDELMAN. No. And again, I wouldn't have any problem doing one before the end of the year.

Mr. ENGLISH. You wouldn't have any problem doing it before the end of the year? Very good. I appreciate that. That's an area I think we want to explore with you. We have a desperate need for rural housing. Housing plays a very important role as far as rural development is concerned. It is an aspect that we've got to focus on and a need that's got to be met. Quite frankly at this point we're searching for the proper mechanism in which to deal with the housing portion. So I think we'll want to talk to Farmer Mac and talk to you about the possibility of making some adjustments so that perhaps the numbers are more realistic in meeting the rural housing needs.

Mr. EDELMAN. We're very encouraged about the opportunities to provide financing for rural housing. We recognize that it is a tremendous market out there, even at the 2,500 community level. We've been working on developing information about the size and breadth of that market and it is really remarkable. There are a lot of opportunities out there. It is interesting to note that approximately 90 percent of the people who live in rural housing are not engaged in agricultural production. So this is a very different credit from the agricultural real estate and one of the questions we're asked frequently is whether these pools would possibly be mixed. We don't believe they would be.

Mr. ENGLISH. The other question that comes to mind, given the limitation of 2,500, obviously communities of 2,500 are very small communities. Would a rural housing pool be more attractive if it were to include a larger population center as up to maybe 10,000 or maybe even to 20,000 population?

Mr. EDELMAN. I believe it would. Yes.

Mr. ENGLISH. So that would lend stability and make the pool more attractive and it would make it easier than to pool loans from smaller communities.

Mr. EDELMAN. That's a fair statement.

Mr. ENGLISH. Thank you very much.

Mr. Coleman.

Mr. COLEMAN. Mr. Edelman, thank you for your testimony. I want to get to the point which apparently is holding up your func-

tioning very well and that is due somewhat to the lack of movement and action by the Comptroller's Office on these issues about originating banks having to have reserves equal to the entire amount of the loan as opposed to the exposure of the 10 percent retained interests that they have. When did you get the idea that the Comptroller was not going to be expeditiously issuing this order or approving this?

Mr. EDELMAN. I would say in August.

Mr. COLEMAN. August. Had you just assumed that they were going to do this or had there been past communications?

Mr. EDELMAN. I became President of Farmer Mac on June 1 and within approximately 10 days of that date I met with Mr. Clark, the Comptroller, and talked about how we might proceed with Farmer Mac and I was encouraged from that meeting. I subsequently had several other meetings with members of his staff and as things came to pass, I saw these obstacles building in front of us to the point where finally we had a meeting in which they informed us that the only way they could see Farmer Mac proceeding would be if were to go back and get the legislation changed.

Mr. COLEMAN. That's interesting, Mr. Edelman, because, while you were not part of this process, we were and the Department of Treasury was as much a presence as anybody in drafting this legislation. They were in the room all the time. Everything was run by them. This comes as a surprise when after the legislation was enacted and was approved by the administration, signed into law by the President, to now say that somehow we're going to have to change the law. Now you weren't here so I can't hold you responsible but there will be somebody testifying from the Comptroller's Office. That's not the way that we think that things ought to happen around here. I would hope and I gather that you have gone in a very conciliatory fashion, along with the representatives of the banking community, to try to resolve this issue.

Mr. EDELMAN. Indeed.

Mr. COLEMAN. I understand that there was a possible resolution or at least a meeting called for yesterday afternoon on the eve of this hearing. That meeting didn't transpire?

Mr. EDELMAN. No, it did not. The Comptroller was called away and he and I are going to have to reschedule.

Mr. COLEMAN. Is there good faith on all sides of this issue or is there with new people coming in and out of the Department of Treasury—is this part of it, do you know? Do you feel that they are structuring—I understand that there is some discussion about redoing some of these others, Fannie Mae and so forth. This is a change of policy down there at the Treasury Department. Is that correct?

Mr. EDELMAN. I think without knowing what the policy is at Treasury on this—if I may refer back to proceedings where I wasn't present but I've read the legislative history and I've talked to people who were present—at that time the intent was that Farmer Mac should act the way some of the other GSE's, Fannie and Freddie and Sallie, do toward their respective borrower constituencies. That is, to provide these benefits of the secondary markets. Everyone was envisioning that Farmer Mac would work the way those other agencies work. If anyone saw a problem with that, be it Treasury or the Office of the Comptroller of the Currency, or

any other agency that was involved in those deliberations, those assumptions were very obvious to all the parties and they could have raised an objection at that time, certainly. You can only conclude, as you have, that if they didn't raise an objection then and there is an objection being raised now, perhaps there was a change of policy.

Mr. COLEMAN. From your background, and I know it's an extensive background in securities in this world of finance, do you envision that if this ruling does not come down in favor of the Corporation that basically you're left sitting at your desk not doing a whole lot?

Mr. EDELMAN. I'm sure we'd find some things to do. But on the other hand, I wouldn't like to be in that position. I'd emphasize it is not a ruling that is being requested here. I've had a letter in to the Comptroller now since September 20 asking merely that as a matter of policy he determine to give Farmer Mac the same treatment as Fannie Mae, which has a very similar program in terms of its consequences for the banks, in fact greater exposure for the banks than Farmer Mac's program. It is a policy decision, it is not a ruling, it is not a regulation. We're waiting for a response.

Mr. COLEMAN. But the banks won't participate unless you have that.

Mr. EDELMAN. It would be very difficult for the banks to participate without that.

Mr. COLEMAN. So you wouldn't be doing a lot until this is done?

Mr. EDELMAN. That's a fair statement.

Mr. COLEMAN. Thank you.

Mr. ENGLISH. Mr. Stallings.

Mr. STALLINGS. Thank you, Mr. Chairman.

Mr. Chairman, I ask unanimous consent to have an opening statement entered into the record at the appropriate place.

Mr. ENGLISH. Without objection, so ordered.

Mr. STALLINGS. Mr. Edelman, I appreciate your testimony. I have not had a chance to review the entire document but I do appreciate your efforts.

Just a couple of questions for my own interests: Has this operation, Farmer Mac, come together in a rather difficult fashion? Have you had problems? Have there been pitfalls that you didn't anticipate? What's been the response from the Department of Treasury?

Mr. EDELMAN. Our dealings with Treasury have been very limited. We have requested that Farmer Mac securities be given book entry treatment. We've been assured several times that we were going to have a response from them and we have not yet had a response. My understanding was that this was originally to have been a given for Farmer Mac and it is a matter of some concern to us that it is not forthcoming.

Mr. STALLINGS. Is this because the appropriate people have not been appointed over at Treasury? Are there some holes in those offices waiting for a Presidential appointment or are there other reasons?

Mr. EDELMAN. I don't know what the reasons are, sir.

Mr. STALLINGS. What kind of input have you had from various banking committees, as you've started putting together the regula-

tions and the ground rules by which this secondary market is going to operate?

Mr. EDELMAN. Banking associations?

Mr. STALLINGS. Yes.

Mr. EDELMAN. We've had some very positive input. The ABA has been supportive. The IBAA has been supportive as well. I think the IBAA had some concerns that really required only clarification. We didn't have to change our standards. Once those clarifications were made, I think we have the unanimous support now of the ABA and the IBAA for what we're doing.

Mr. STALLINGS. Thank you. Thank you, Mr. Chairman.

Mr. ENGLISH. Mr. Morrison.

Mr. MORRISON. Thank you, Mr. Chairman.

I've benefited from a briefing by Mr. Edelman's team during a visit to my office. I'd have to say that the most recent hitch is coming from another agency, but I'm a very pleased member of this subcommittee working on this subject to see the progress that's been made. I would ask only one question. Mr. Edelman, as you see it, is there enthusiasm out there among the folks that would make up the sales force—poolers, the financial institutions—for Farmer Mac as you see it going together?

Mr. EDELMAN. Yes, there is enthusiasm but there is also impatience. There is also a certain amount of frustration. Part of the impatience comes from the fact that people had to buy the stock 1 year ago and only now are they first getting an opportunity to participate in Farmer Mac. I think that was just a reality of statutory requirements for different time periods. However, there is also a lot of frustration because the press has done a fine job of covering some of the regulatory hurdles we need to get over and people are wondering whether we'll clear those hurdles. And so there is a certain disenchantment that's being precipitated by these problems.

Mr. MORRISON. Was the investment in the stock, would that investment have been made under most circumstances if they had known the position the Comptroller was eventually going to take?

Mr. EDELMAN. I couldn't comment on that.

Mr. MORRISON. Mr. Chairman, my reaction as I've looked at this is that movement is in a very positive direction. As a member of this subcommittee, I will do whatever is helpful in removing this barrier that now seems to be in front of us that I think dramatically changes the dimensions and would have a significant impact on the enthusiasm just described.

Mr. ENGLISH. Mr. Gunderson.

Mr. GUNDERSON. Thank you, Mr. Chairman.

Mr. Edelman, I've been trying to quickly go through your testimony here to respond to some of the concerns regarding the diversification and the lending limit capacity, and so forth. Can you sort of update me as to what you think the final outcome on these might be? Could you give me a prediction? I had the chance earlier this week to meet a lot of the Farm Credit System people and I've got to say there's concerns out there as to whether or not there's going to be a viability when we're all done. Where do you see the final resolution in the Office of the Comptroller—some of their attitudes, and hopefully some of yours, and obviously the views in the secondary market?

Mr. EDELMAN. I would like to think that we'll be able to resolve things with the Office of the Comptroller of the Currency. I've spoken a couple of times with Mr. Clark and he certainly seems like a reasonable man. I like to give people the benefit of the doubt that there is no conspiracy there or anything like that. I think that it is simply a matter of a misunderstanding of how Farmer Mac is going to operate and the benefits that Farmer Mac will bring to the banks that the Comptroller of the Currency regulates. Farmer Mac is a real opportunity for those banks to lay off interest rate risk on the market. They could eliminate one of their most difficult problems, which is managing their assets and liabilities so that the interest rates they are paying on their borrowings would be matched relative to the assets that they create by making loans. They have to earn more on the loans they make than they pay out on their borrowings and making that happen in all economic environments is a real challenge.

Participating in the Farmer Mac Program would be an opportunity for them to put that challenge aside and concentrate on other aspects of loan administration, particularly credit. But there again Farmer Mac standards should improve the world of credit management for them and the potential for sharing exposure to risk with other participants in Farmer Mac should also be a plus for them. We think that our standards create a real opportunity to strengthen community banks and the Farm Credit System by letting them concentrate on the things that are most important to their customers.

Mr. GUNDERSON. That's where you're coming from. Let's assume that we don't resolve this dispute. If the position taken by the Comptroller becomes the final position, do you think anybody will ever use this?

Mr. EDELMAN. I think we would have to restructure it, possibly come back and change the legislation, but I think we would certainly have to restructure how Farmer Mac would operate. That would require reorienting a lot of people who are very excited about Farmer Mac operating the way it has been intended to operate and getting them excited again about a new orientation, which is a real challenge.

Mr. GUNDERSON. Are there any ambiguities in legislative statutes or as you read the legislative history that need to be clarified in order to reestablish the viability of secondary markets in terms of the dispute that presently is on-going?

Mr. EDELMAN. I would like to say that we should be able to resolve it within the scope of the statute that now exists.

Mr. GUNDERSON. And if that's not the case, you will come back to us?

Mr. EDELMAN. We certainly will.

Mr. GUNDERSON. With legislative language?

Mr. EDELMAN. Yes, but again I would like to emphasize that doing that would be a long process and could further disenchant a lot of the people who expect to participate in Farmer Mac. It's only so long you can keep pumping up people's expectations and then failing to deliver. I feel that if we had to come back for new legislation, it would delay the startup of Farmer Mac in a way that would really imperil its future operation.

Mr. GUNDERSON. I'm a little confused by the timing. I'd sort of been led to believe that once the hearings had been heard by the Banking Committee and hearings here are completed that we're then looking at a 30-day process to 60-day process in which we would then see the issuance of regulations, is that correct?

Mr. EDELMAN. We would not be issuing regulations. We would be issuing a Securities Guide which would basically be the cookbook for people to use in participating in the program. Once that was out, we would be looking for people to come to us with pools before the end of the year. We think that we could have the Securities Guide out approximately 2 to 4 weeks after the conclusion of the congressional review period in mid-October.

Mr. GUNDERSON. At this point in time, you issue the Securities Guide?

Mr. EDELMAN. We have not yet.

Mr. GUNDERSON. But you will be the ones that do that?

Mr. EDELMAN. That's correct.

Mr. GUNDERSON. Will you base that on your and the committee's understanding or will you base that on the Comptroller's policy?

Mr. EDELMAN. We will base that upon our understanding. It is independent of bank regulation. It is just a question of whether bank regulation permits bankers to participate on an economically realistic basis in our program, but the program itself and the way we would write the guide really would be unaffected by the outcome of those discussions.

Mr. GUNDERSON. Thank you.

Mr. Chairman, I would like to ask that if possible, perhaps at a later time this week after I've looked over some of this material, to submit some written questions for the record.

Mr. ENGLISH. You'd have no objection to written questions being submitted, would you?

Mr. EDELMAN. I've be very happy to answer any written questions.

Mr. ENGLISH. I think that's a good point. Without objection, so ordered.

Mr. GUNDERSON. Thank you.

Mr. ENGLISH. Mr. Penny.

Mr. PENNY. Thank you, Mr. Chairman.

Mr. Edelman, it is my understanding that under Sallie Mae, which authorizes poolers within geographic areas, there is kind of an exclusive situation in which certain States have one pooler and others a different one. You intend to do this on an overlapping basis. Can you discuss the relative merits of that approach?

Mr. EDELMAN. Sure. Having first of all two distinct groups of institutions—Farm Credit System and non-Farm Credit System institutions—means that the way we are structured there could be a Farm Credit System pooler which, in fact, has been formed, and also non-Farm Credit System poolers. The way we've structured Farmer Mac both of those can overlap each other in the sense that Farm Credit System poolers may pool loans both within the System and from non-Farm Credit System originators. Likewise, non-Farm Credit System poolers can pool Farm Credit System loans as well as non-Farm Credit System loans. That's one type of overlap.

In addition to that, there may be more than one Farm Credit System pooler in the future. I think it is too early to say how that's going to be structured. But in addition to that, there are opportunities for different types of institutions to pool. We have already seen commercial banks, insurance companies, and investment banks, and actually other organizations as well—one State agency—purchase the stock to become poolers for Farmer Mac. It is already a competitive market out there in terms of agricultural loans and residential loans and we think that the evolution of Farmer Mac will best be served by permitting competition among the poolers and so that's how we've designed it.

Mr. PENNY. I have a question that you may not want to answer but tomorrow on the House floor we're going to vote up or down a restoration of a capital gains differential in our Tax Code. The major feature of that capital gains tax break is a dramatic decline in the rate for 2 years, replaced then by a more modest kind of indexing feature for the future. The strong concern is that that's going to spur an awful lot of liquidation of assets in the next 2 years to take advantage of that break and that future investment will be relatively less attractive in comparison to whatever you can do in the next 2 years. I am concerned specifically about the effect on agricultural real estate. An awful lot of land—due to the crisis of the 1980's in agriculture—is now held by institutions and relatively wealthy individuals who have no real reason to hang on to that land. They are renting it for the most part now, and with a significant tax rate reduction, they might be inclined to dispose of that land rather rapidly. I'm just curious to know if you read it the same way I do and what that could mean to our agricultural industry and the debt load and the viability of Farmer Mac?

Mr. EDELMAN. That's a fairly global question. I think that the basic answer I would give you to that is that people who invested in agricultural land on a nonoperating basis who chose to sell it could be creating opportunities for either other investors or for agricultural operators to acquire it. Farmer Mac is really geared to the operators and this could very well give us some opportunities to do some interesting guarantees of loans that would facilitate acquisitions by farmers.

Mr. PENNY. My concern gets more to what this does to land values and that's a good news, bad news scenario. The good news is it could open up opportunities for beginning farmers who can't come up with a sizeable down payment to actually afford to buy an acreage. The bad news is that we have an awful lot of farmers who are leveraged against current asset values and if we have a precipitous sell-off of a significant amount of farmland, values drop rapidly, then we've got people who don't have the value to back up their debt. What about that?

Mr. EDELMAN. Farmer Mac has a loan to value ratio requirement of 75 percent and in some instances it would be only 65 percent of the appraised value of the land. As long as we're getting sound appraisals, Farmer Mac should not be exposed to speculative movements and we don't believe that we will be a force for driving prices up or down. Your concern that prices may move down is one that we would of course want to think more about but we believe that the 75 percent loan to value ratio protects us.

Mr. PENNY. I guess the bottom line is that while there may be some disruption out there and some negative consequences from that, you don't see it having a direct impact on the viability of Farmer Mac?

Mr. EDELMAN. I don't believe there would be a serious impact.

Mr. PENNY. Certainly there could be some of that dislocation which would occur if values dropped precipitously and farmers are leveraged in such a way that that decline in asset value undermines their standing with their lender.

Mr. EDELMAN. When I look at the situation and the impact on Farmer Mac I look at the fact that if we're requiring 25 percent equity in the loans—that is 75 percent loan to value ratio, the flip side of that is 25 percent equity—and an additional 10 percent of either reserves or subordination is being provided. This provides about 35 percent protection to Farmer Mac relative to its guarantee exposure. Unless we were to go through something as serious as the crisis of the early 1980's, where we were talking about numbers on the order of 50 percent, I think that this will be a lesser impact and Farmer Mac could easily withstand it.

Mr. PENNY. Thank you, Mr. Edelman.

Thank you, Mr. Chairman.

Mr. ENGLISH. Thank you very much.

Mr. Edelman, I believe that completes the questions that we have. We appreciate your testimony. We're going to be looking forward to working closely with you in dealing with these problems and hopefully it won't be necessary for us to reopen this issue. I think you can tell from the tone of this committee that we feel very strongly that Farmer Mac is important and we intend for it to work. There is a need out there and we don't intend to neglect that need. We appreciate your testimony and we'll be watching very closely the discussions that are taking place and we're hopeful that it will work out.

Mr. EDELMAN. We appreciate your interest.

Mr. ENGLISH. Thank you, Mr. Edelman.

We next have a panel consisting of Mr. Mike Grove, who is president of the First National Bank of White Sulphur Spring, Montana, and he's representing the American Banker's Association; and Mr. Jack Dickey, who is president of the First National Bank of Thomas of Thomas, Oklahoma, and chairman of the Agriculture-Rural America Committee of the Independent Bankers Association of America. I want to welcome both of you gentlemen and, as I mentioned to Mr. Edelman, I hope that you'll feel free to summarize your written testimony and without objection your written testimony will become a part of the record.

Mr. Grove, we'll let you lead off.

STATEMENT OF MICHAEL GROVE, PRESIDENT, FIRST NATIONAL BANK OF WHITE SULPHUR SPRING, MT, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. GROVE. Thank you. Mr. Chairman and members of the committee, my name is Mike Grove, president of the First National Bank of White Sulphur Springs, Montana, which is a national bank regulated by the OCC, and a member of the American Bank-

ers Association's agricultural bankers division executive committee. My institution purchased enough Federal Agricultural Mortgage Corporation Class A stock to become eligible to participate in the program as an originator. I am here today representing the American Bankers Association.

In Montana there is much enthusiastic anticipation in the farming community and in the banking community for the prospects of long term, fixed rate real estate loans. The farmer and the banker welcome this new choice for their financing needs. The combined assets of ABA members comprise approximately 95 percent of the total assets of the commercial banking industry, including 5,000 agricultural banks. While our members range in size from the smallest to the very largest, some 85 percent have assets of less than $100 million. My bank has $20 million. One of the advantages that the American Bankers Association has in its discussion of Farmer Mac is that we have access to the resources of small community and agricultural banks, regional banks, and money center banks which have an interest in restoring economic vitality to the rural communities of this country through a secondary market for agricultural real estate and housing loans.

Mr. Chairman, I know of your support to expand the size of the cities from 2,500 to a higher level and we likewise would support that move.

The ABA has recognized the need for the development of a secondary market for agricultural loans, particularly agricultural real estate loans, since the late 1970's and the early 1980's. In 1987, in cooperation with the American Council of Life Insurance, the Independent Bankers Association of America, and major farm groups, ABA worked with Congress to authorize a secondary market for agricultural real estate and rural housing.

The ABA has continued to play an active role in the development of the market, working with the Farmer Mac Interim Board of Directors, the permanent Board, and various developmental task forces. The ABA was also instrumental in the sale of common stock involved in the initial capitalization of Farmer Mac. We are proud of the role that we have played in the past in bringing Farmer Mac to this stage of development and we look forward to working with the Congress, the Board, and the agricultural and housing industries as Farmer Mac moves forward to help address the credit needs of rural America.

This secondary market for agricultural real estate was created for some very specific purposes. It was designed to provide competitive sources of financing for agricultural real estate to the farmers and ranchers of this country. It was designed to provide a source of long term, fixed rate financing to farmers and ranchers at a reasonable cost. It was also designed to provide a financing mechanism that reduced some of the volatility in the provision of credit to agriculture. It is important to reiterate these goals for this secondary market before focusing on a few of the specific details of Farmer Mac's structure lest we all lose sight of the reasons for its creation. These are important goals and Farmer Mac must be viable to achieve them.

Having noted the goals of Farmer Mac, let me state at the outset that ABA has always believed that the underwriting standards

should be designed to ensure the safe and sound operation of the secondary market. They must provide confidence to farm borrowers, lenders, investors, and other participants in the secondary market, and the American taxpayers who ultimately stand behind the securitization process of the secondary market. At the same time, we feel that the underwriting and appraisal standards of Farmer Mac must be flexible enough to ensure the broadest possible availability of credit without damaging the market's safety and soundness. To err toward either extreme would, in our view, lessen the considerable potential of the secondary market to revolutionize agricultural lending in the years ahead. It would deprive many deserving farm borrowers and rural homeowners of the many benefits that Farmer Mac has to offer. Thus, after careful analysis of the draft standards, we offered a series of concerns and proposals for modification which we wanted to see incorporated in the underwriting standards.

It is apparent to us that the Farmer Mac Board took note of our proposals—and the proposals of others—in amending the discussion draft standards. To illustrate, we have prepared an attached document that compares the original draft standards, ABA's comments from our May 5 testimony presented to the Farmer Mac Board, and the amended standards which were sent to the Congress on June 30.

We believe these standards are reasonable and workable. When the ABA's agricultural bankers division executive committee met in July, they released a statement commending the Farmer Mac Board for its expeditious action in developing a framework for the provision of credit in the secondary market. The timeframe was and is short; the achievements on the part of the Farmer Mac so far are commendable. Significant problems for the development of Farmer Mac remain, but the efforts of those involved so far must be applauded.

Therefore, our testimony today is based on a belief that the standards as written provide the flexibility needed for financing the purchase of farm real estate and rural housing. This flexibility is best illustrated by inclusion of credit underwriting standard No. 9 which states: "Farmer Mac may, on a pool-by-pool basis, accept loans that do not conform to one or more of their standards."

Furthermore, when concern arose recently over the interpretation of the term "Net Property Income Valuation," the Farmer Mac Board was able to allay these concerns because of the way the credit underwriting standards and appraisal standards work together to allow flexibility. In the end, the Farmer Mac Board was able to issue clarification notes that indicated how "Net Property Income Valuation" would be determined when an existing farm owner/operator used Farmer Mac financing to purchase additional farm land. This clarifying note confirmed ABA's original interpretation of the appraisal and underwriting standards.

As a final comment on the credit underwriting standards, the ABA must stress again that the profitability is the key element affecting whether a farm can operate and survive long term. Therefore, when a farming operation demonstrates a history of profitability but does not conform to all of the ratios outlined in the credit underwriting standard, Farmer Mac should use its discretion

to accept the loan under credit standard No. 9. If Farmer Mac ignores profitability, and focuses too heavily on ratios—such as the debt to asset ratio—it may lead to asset-based lending.

In examining the "Eligibility Standards for Certified Facilities," it is difficult to comment on many of the proposed criteria for certified facilities issued by Farmer Mac because there are frequent references to the as yet unpublished securities guide. Obviously, until the securities guide is available, we are unable to give its contents careful analysis. As an example, the reference to compliance by loan originators and servicers with environmental management procedures contained in the securities guide is the type of specific procedures that the ABA must comment upon when the guide is available.

Furthermore, the criteria direct certified facilities to identify capable originators and enter into agreements with originators on a variety of matters relating to originating and servicing of loans. This requirement causes ABA to have some concern for small originators who may deal with only a few loans each year. These concerns are detailed in the written testimony which is made part of today's record.

We believe that for Farmer Mac to fulfill its promise to the agricultural community, it must ensure that there is ready access to Farmer Mac programs by all stockholders. Participation by many loan originators is the best way for the benefits of Farmer Mac to be delivered to farmers and ranchers, large and small, throughout the Nation. ABA believes strongly that there must be competition between both originators and poolers. Therefore, we look forward to the publication of the Securities Guide which we hope will further clarify our understanding of the more general underwriting and certification standards and ensure that the interests of small institution originators and individuals with small farms will be protected.

However, we still do have very real concerns because there are issues which, if not corrected by the regulators, may have to be addressed in the legislative arena for Farmer Mac to become operable. We plan to continue working with the Farmer Mac and the banking regulators to develop means for the regulators to treat loans sold to the secondary market as assets sold and removable from the books of bank originators. Similarly, there remain significant questions as to the regulatory treatment of securities created by bank poolers under the program. ABA will continue to be involved in this issue as well.

Mr. Chairman, the capital issue raised by the OCC is a major obstacle which must be resolved for this program to be successful. For example, they assume banks will retain 10 percent subordinated interest, and the risk associated with that. We believe that this is only one of many alternatives that will be negotiated between originators and poolers. Also, we support the position of the Farmer Mac Board and Congress to allow book entries of the securities process.

These last concerns are part of a major complicated issue. We look forward to working with the Farmer Mac Board, regulators, and Congress to resolve these major obstacles to Farmer Mac's fulfillment of its promise. This new financing mechanism is a neces-

sary part of rural development. ABA is convinced that any obstacle to its implementation should be overcome as soon as possible to ensure the economic viability of agricultural in small towns in this country.

Thank you.

[The prepared statement of Mr. Grove appears at the conclusion of the hearing.]

Mr. ENGLISH. Mr. Dickey.

STATEMENT OF JACK W. DICKEY, PRESIDENT, FIRST NATIONAL BANK OF THOMAS, OK, AND CHAIRMAN OF THE AGRICULTURE-RURAL AMERICA COMMITTEE, INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. DICKEY. Good morning, Mr. Chairman, members of the subcommittee, I am Jack Dickey, president of the First National Bank of Thomas, Oklahoma. I also serve as chairman of the agriculture-rural america committee for the Independent Bankers Association of America. It is in that capacity that I am testifying today.

The IBAA is strongly committed to the success of the Farmer Mac Program and we appreciate the opportunity to testify before you this morning. It is very constructive and timely for Congress to review Farmer Mac's operations.

Two recent developments involving Farmer Mac are noteworthy. On September 1, the Federal Agricultural Mortgage Corporation issued an important position statement which assures that Farmer Mac will work successfully through community banks and other local originators. This statement is attached to these minutes along with the IBAA's response. Independent rural banks are eager to provide this new source of long-term real estate credit to farmers and ranchers and for the housing loans in our communities.

On September 20, Farmer Mac submitted a request for a ruling to the Comptroller of the Currency, Robert Clarke, regarding the treatment of Farmer Mac loans for commercial banks concerning legal lending limits and capital requirements. This letter is also attached. Before discussing each of those developments, I would like to briefly discuss the role that community banks played in capitalizing Farmer Mac.

The IBAA is and has been deeply involved with Farmer Mac for over 3 years. First, we were concerned that farmers and ranchers would have access to the money markets for real estate loans. Second, that these loans should be originated by local agricultural banks throughout the farm belt. The statute singled out two parties—originators and certified facilities—who were charged with capitalizing Farmer Mac and carrying out the program.

Early in 1988, IBAA requested a ruling from the Comptroller of the Currency and from State authorities in major agricultural States specifying that national and State-chartered commercial banks would be permitted to purchase stock in Farmer Mac. The Comptroller's letter of approval is attached.

The statute provided that at least $20 million of stock be sold. Both originators and poolers were required to purchase a specified amount in order to originate or pool loans. The IBAA worked closely with Farmer Mac and the stock underwriters to assure that com-

munity banks were informed and had sufficient time to consider the purchase. Various organizations representing farm producers stressed the importance of local lenders to buy stock so farmers and ranchers could be provided loans on the local level.

In the initial offering, approximately $22.4 million of stock was sold. Financial institutions other than the Farm Credit System purchased $13.4 million of this stock. Some 1,600 originators purchased 51.5 percent of the stock, and approximately 30 firms bought the balance to be potential poolers. Almost 1,500 of the originators were smaller community banks. Of these, 74 percent have assets less than $50 million and 87 percent have assets of less than $100 million.

We have attached to this statement a list of those States having a least 10-bank stockholders in Farmer Mac. It is now very important that community bank stockholders, having contributed in a major way toward the capitalization of Farmer Mac, be able to participate on a broad basis. This is essential for the success of Farmer Mac.

On September 1, Farmer Mac addressed a position statement to the IBAA. This statement specified several areas of affirmative action that Farmer Mac will take to assure fair dealings between poolers and originators. Farmer Mac was responding to concerns IBAA raised 3 months ago when the eligibility standards for certified facilities were issued. These concerns were raised first with Farmer Mac, its Board, and then Congress.

The September 1 letter represents a positive commitment by Farmer Mac to assume an active oversight role in this market. This is necessary for smaller originators to fully participate. In that letter, Farmer Mac made the following commitments:

One, that Farmer Mac will take a affirmative action to promote the participation of community banks as originators.

Two, relationships between loan poolers and originators must be fair and reasonable. Farmer Mac has pledged to review pooler-originator contracts for consistency with a fair and reasonable standard and to investigate promptly each bona fide complaint of a breach of the fair and reasonable treatment.

Three, poolers may not bypass local originators, banks, or others who are Farmer Mac stockholders.

Four, Farmer Mac is committed to the principle that community banks may service the loans they originate and will take remedial action against any pooler who seeks unilaterally to deny an originator the right to service a loan.

In addition, Farmer Mac made constructive changes in the loan underwriting standards. It will be somewhat easier for farmers to meet the cash-flow requirements for the purchase of add-on farmland where the overall operation shows a strong debt repayment capacity.

We believe this letter from Farmer Mac provides a sound basis for moving forward. The affirmative role Farmer Mac has defined is critical to protect the prerogatives of stockholder originators and reach the local farmers and ranchers that Congress intended.

We recognize that these positive steps would not have occurred without the active involvement of Congress. We appreciate your scheduling these hearings and being involved.

There are some important bank regulatory issues involving legal lending limits and capital requirements that still must be worked out. The lending limit question is critical for the smaller community banks that are heavily involved in agricultural lending. With many of their farm customers, the banks are at or near their legal lending limit. It is important that the sold portion of the loan not apply against the bank's lending limit.

Although the subordinated portion of Farmer Mac loans and loan pools carries a disproportionate share of the risk, the Farmer Mac Program includes several elements that reduce the risk to participating banks:

One, the so-called catastrophic risk—the risk of loss in excess of 10 percent of the pool—is assumed by the Federal Agricultural Mortgage Corporation.

Two, the stringent Farmer Mac underwriting, appraisal, and repayment standards are designed to assure that only prime loans qualify. Loss exposure on such loans should be much lower than losses on agricultural loans in general.

Three, interest rate risk to the bank is eliminated on the portion of the loan that is sold.

Those risk-mitigating factors and the congressional intent that commercial banks be allowed to participate should provide a basis to resolve the legal lending limit issue.

The capital adequacy issue is also critical to banks' participation. If banks have to provide capital for the 90 percent sold portion, the additional costs may outweigh the benefits and prevent bank participation.

The IBAA, ABA, and Farmer Mac have joined in a request to the Comptroller of the Currency asking that Farmer Mac loans be given equivalent treatment as loans in the Government-sponsored residential mortgage programs, such as those programs administered by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. A copy of this letter is also attached.

Under Fannie Mae, the originating bank assumes the entire risk of loss for borrower's default on loans sold and yet current OCC policy treats such transactions as "sales" that permit banks to remove the mortgages from their balance sheets. Since the Farmer Mac Program is similar, the September 20 letter asks for parity. The letter states that this parity should apply equally to capital adequacy and legal lending limits. It is essential the portion of the loan sold move off the bank's balance sheet for purposes of determining both the legal lending limit and capital adequacy. Unless banks retain a participation in these loans, they most likely will not be allowed to service the loans and thus the local contact that Congress intended will be lost.

The IBAA stands strongly behind the September 20 recommendation by Farmer Mac for resolving the bank lending limit-capital issue. We want to work with you in Congress toward an early resolution of this matter. The Comptroller's door has been open to the IBAA on this issue and we believe he is sympathetic toward finding an acceptable solution.

There is much work yet to be done. We are optimistic that Farmer Mac can begin handling loans before the end of the year

and that the market will operate successfully. The IBAA joins with Farmer Mac in a commitment to work together to achieve that goal.

Mr. Chairman, that concludes my prepared remarks. I would be happy to respond to any questions.

[The prepared statement of Mr. Dickey appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you very much, Jack. I appreciate your testimony.

With regard to the Farmer Mac underwriting standards, would they be strong enough for you to make a loan for your own bank's portfolio?

Mr. DICKEY. Absolutely.

Mr. ENGLISH. Mr. Grove.

Mr. GROVE. Yes.

Mr. ENGLISH. You would agree with that as well?

Mr. GROVE. Very much.

Mr. ENGLISH. You heard me raise the question with Mr. Edelman with regard to rural housing. Both of you are from rural communities. I think there is no question as far as economic development is concerned that housing is a primary issue. We've got to have decent housing. In your opinion, do you think Farmer Mac would be the right vehicle to use? We already have provisions for communities of 2,500 population and less. Would you support increasing that population level up to say 10,000 or 20,000?

Mr. DICKEY. Yes, sir; I certainly would. I think that's a very logical step, a manner in which to provide rural housing through the money markets rather than Government funds.

Mr. ENGLISH. Mr. Grove.

Mr. GROVE. We would, too. The opportunities for rural housing out there, as you well have pointed out, are very large, and it is not just in communities of less than 2,500. An increase in that population level would be very much supported.

Mr. ENGLISH. Given your knowledge of rural communities—small towns that are over 2,500, those that would be say 5,000 or 10,000—can they find adequate financing today given the difficulties we've faced in so many agricultural communities throughout the 1980's?

Mr. GROVE. In our particular State, it is very difficult for that to happen. We are in the process now of just beginning to find outside interest in our State. Montana is kind of the place to be right now. There are so many restrictions on rural housing loans—like water systems and sewer systems, and some of the structural infrastructure things—that just are not available in rural communities and that's in communities of 5,000 or 10,000 people.

Mr. ENGLISH. Jack, what do you think?

Mr. DICKEY. The mortgage market in Oklahoma today is very limited, restricted. It is difficult to find the mortgage companies to place the loans with in the first place. I think the Farmer Mac Program could be a major influence in helping rural housing. I like your limit request, Congressman, of 20,000 as opposed to 10,000 because we have a couple of communities in our county that are very close to that.

Mr. ENGLISH. Well, according to the Farmers Home, their definition of a "rural community" is 20,000 or less. We've also got the

Census Bureau's definition of "counties," and, of course, with counties it's a population of 50,000 or less. But I think that this has to play a vital role. We need financing. Would it be going too strong to say that unless Farmer Mac is given the opportunity to work and provide housing needs for rural communities, it is highly unlikely that the majority of rural communities around this country are going to find adequate funding for rural housing? Would that be going too strong, Jack?

Mr. DICKEY. No, sir, I think that's an accurate statement.

Mr. ENGLISH. Mr. Grove.

Mr. GROVE. I think that's a very good observation.

Mr. ENGLISH. Mr. Coleman.

Mr. COLEMAN. Gentlemen, when I asked Mr. Edelman if banks would participate without this Comptroller ruling or statement, in effect, you probably wouldn't be interested and many would not participate in Farmer Mac, is that correct?

Mr. GROVE. Mr. Coleman, we're a small bank, only $20 million and we don't envision a whole lot of activity out there. But I perceive that lending limit restriction that they are working on right now to be a major stumbling block. As has been testified to earlier today, the financial community and the agricultural community are really excited about this product. The prospects of fixed rate financing out there—and from the banker's view, the ability to provide that to the farm community which we've never before been able to do—1,600 new competitors providing agricultural loans I think is exciting to the borrowers. The fixed rate facet of that is there. But if we have to count on our lending limit the loans that we make to our farmers—and I think that's the biggest prospects we have as our existing customer base—we may be at or near the lending limit already with those and that's going to preclude us from not being able to service the people who want it the very most and we're closest to. So I think it is a major set back.

Mr. COLEMAN. Mr. Dickey, do you agree with that?

Mr. DICKEY. Yes, sir. I anticipate that most of the loans, most of the opportunities we would have to place loans through Farmer Mac would be with our existing customer base. We're already extending large cattle lines, crop loans, equipment loans to these customers. If you say now you're going to carry a $200,000 legal lending limit on a real estate loan, I couldn't carry that additional credit in my bank.

Mr. COLEMAN. Both of you represent the banking community in the country here and I wonder if you have been actively involved with discussions with the Treasury Department on this and do you think that this matter might be resolved through negotiation and discussion with your institutional representatives?

Mr. GROVE. I haven't been actively involved myself, but from what I understand from the American Bankers Association, they are working very closely with the OCC. The hope is to resolve this, get the issue behind us, and get on with the program.

Mr. DICKEY. Mr. Congressman, I have been involved in discussions with representatives of the Comptroller's Office with other members of the IBAA. They have some problems within their existing policy rules/regulations in handling Farmer Mac. However, in these discussions we have tried to suggest alternative ways it could

be approached. I think the letter of September 20 from Farmer Mac provides a good approach to resolving the issues. Hopefully, we can pursue that with the Comptroller's Office and get it worked out.

Mr. COLEMAN. Thank you, gentlemen.

Mr. ENGLISH. Mr. Stallings.

Mr. STALLINGS. Thank you, Mr. Chairman.

Mr. Dickey, are you satisfied smaller banks will be able to participate in Farmer Mac?

Mr. DICKEY. Provided we resolve the lending limit and capital adequacy questions.

Mr. STALLINGS. There were previously some concerns from your organization that the way the standards were being put together they would exclude smaller banks. Has that been resolved?

Mr. DICKEY. I think the Farmer Mac's portion of it, yes, sir. I think the issue statement of September 1 resolved quite a number of concerns involving the local originators and their rights with the poolers. They have indicated that they would provide oversight in that area. We were concerned primarily with a monopoly or a very limited number of poolers coming into this market that could not really generate the competition that's needed to make it work.

Mr. STALLINGS. But those issues have since been resolved and your organization feels very comfortable with them?

Mr. DICKEY. Yes, sir.

Mr. STALLINGS. Thank you, Mr. Chairman.

Mr. ENGLISH. Mr. Penny.

Mr. PENNY. Thank you.

Mr. Dickey, did your bank experience a significant number of borrowers who were in financial trouble in the mid-1980's due to declining land values, declining prices for commodities?

Mr. DICKEY. Yes, sir. My bank was chartered in 1904. I would suggest that we have sustained more loan losses since 1982 than the bank had in its prior history. It has had a significant impact.

Mr. PENNY. You've worked through most of that by this time?

Mr. DICKEY. Yes, sir; I believe we have.

Mr. PENNY. Does it leave some of those distressed borrowers in a situation where their debt to asset ratio is still quite high? I mean, borrowers that you're still carrying, are they still in a situation that's kind of tenuous and any number of factors could put them over the brink?

Mr. DICKEY. Yes, sir.

Mr. PENNY. In that regard, how would you respond to the question I asked Mr. Edelman earlier that if we have—and I assume Oklahoma is no different than Minnesota—a lot of these institutional land holders and others who aren't physically farming the land move a lot of farm real estate to take advantage of lower capital gains rates, because we're only going to have a 2-year opportunity to do that, could that send things into a tailspin with that chunk of borrowers in your bank?

Mr. DICKEY. I heard your conversations earlier with Mr. Edelman and, yes, I think there are definitely two sides to that question. I think Farmer Mac may be an alleviating factor in that decline. At the same time, there are a number of marginal borrowers that are still there making it work barely. But if we would have

another significant decline in land and equipment values, I think they would certainly be taken out of the market. Exactly as to how that would come down, I'm not sure. I think you may see a number of farms moving from the parents to their sons and daughters as an estate tax measure and taking advantage of the lower capital gains.

Mr. PENNY. That's something that we would hope would occur in any event, and in those cases the transfer is not one that would have a negative consequence for our rural communities because we'd be keeping the family operator on the land. But if too much land moves and values move down too rapidly, I know that does cause a problem for your portfolio if you've got a sizeable number of farmers that are in that precarious situation where they are kind of close to the edge now and that decline in asset value could push them over.

Mr. Grove, how about the situation up your way?

Mr. GROVE. I think you could look at it two different ways. I would suggest that it could be the other way as well. With new competition in the market for real estate loans, there may be higher availability of capital which indeed could increase the demand for farm real estate as well.

Mr. PENNY. Which then could help sustain values in spite of the other?

Mr. GROVE. Right.

Mr. PENNY. Well, these situations are always unclear. I know it's a bit unfair to ask you to make a prediction without any advance notice. I do appreciate your testimony this morning. And, like you, I trust that once Farmer Mac is fully in place, we're going to see those positive benefits accrue to our rural communities and our farm borrowers. Thank you very much.

Mr. GROVE. Mr. Penny, I would just like to add to that. I think that's the thing that the market is waiting for. The agricultural community and the lender community is geared up and has lots of anticipation for this to do a lot of good for the farmers. I don't think we've ever seen what could happen. We've never had the availability of competitive long-term real estate loans at a market rate out there and there is no better market than that securities market. I think that's what we're all hopeful about.

Mr. ENGLISH. Ms. Long.

Ms. LONG. I don't have any questions right now, Mr. Chairman.

Mr. ENGLISH. Mr. Nagle.

Mr. NAGLE. Had we had this in place prior to the time of the land boom that lead to this committee and this Congress having to rescue the Farm Credit System, would this have had any impact in deterring that type of experience we had between 1984 and 1987 in the agricultural community?

Mr. DICKEY. I would suggest that with the strict underwriting standards and appraisal guidelines, and particularly the cash-flow requirements, the loans even during that period of time that went into this program, would have sustained some losses due to the deep declines in both real estate values and grain prices. But I think those losses would have been minimal. I don't think that would have prevented the other lenders in the market from going ahead and making—if you'll excuse the expression—the silly loans.

Mr. NAGLE. I didn't hear that term. What was it?

Mr. DICKEY. I don't think that would have deterred the other lenders from making the "silly loans," of loaning 100 percent, forget the cash-flow, it's going to be worth 50 percent more in 3 years, let's do the deal and go on down the road type thing.

Mr. NAGLE. I'm just curious to know. The purpose of the Farmer Mac—and I was heavily involved with it when it was brought here—was to create competition. It would seem to me that had the competition, had it been present, not been willing to make the loans to the Farm Credit System was willing to make—which you characterized as silly loans—that at least might have given them pause or time to reconsider whether or not they were going to do it.

Mr. DICKEY. Yes, sir. I don't mean to imply that the Farm Credit System was the only one making those loans.

Mr. NAGLE. I think we both would agree that they would make the majority of the loans. Now what happens when we go down the line on this and if the OCC is successful in its reserve requirements—and you may have already answered this, but just for my own edification—what impact will that have on the ability of banks to make loans, if OCC pursues their reserve requirements?

Mr. DICKEY. If their capital requirements are too strict, it will at least limit the number and the dollar volume of the Farmer Mac loans that I can carry in my portfolio even if the lending limit problem is resolved.

Mr. NAGLE. Could you expand on those two? What do you mean "lending limit requirement" and "capital requirements?"

Mr. DICKEY. Under the current OCC guidelines, the 10 percent subordinated participation that my bank would retain for lending limit purposes would be treated as though I had retained the whole loan.

Mr. NAGLE. You mean, if you gave a $100,000 loan, you retain 10 percent of that or $10,000 and $90,000 you put into the secondary market, is that the way the system works?

Mr. DICKEY. Yes, sir.

Mr. NAGLE. That has a Government guarantee behind it?

Mr. DICKEY. Yes, sir.

Mr. NAGLE. You've got to carry $100,000 on your books as loaned out?

Mr. DICKEY. It would be treated from the regulatory aspect as though I had a $100,000 loan on my books for lending limit purposes and also capital requirements.

Mr. NAGLE. When you say "capital requirements," tell me what that means.

Mr. DICKEY. Under the Comptroller's risk-based capital guidelines that are coming into play, we will be required to carry an 8 percent capital requirement on that $100,000 loan—$8,000. If I'm carrying a $10,000 loan and I have to retain $8,000 of capital in order to carry that $10,000 loan, that's going to restrict our activities in this market substantially. Based upon the economics, you can't afford to do that.

Mr. NAGLE. I apologize if I'm plowing ground that you've already plowed. Mr. Chairman, if I could have 1 additional minute?

Mr. ENGLISH. Without objection, so ordered.

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Mr. NAGLE. These are the same requirements that the Fannie Maes and Ginny Maes have or is Farmer Mac going to be treated differently by OCC? Does OCC propose to treat Farmer Mac differently than it treats Ginny Maes and Fannie Maes?

Mr. DICKEY. Not at this point. But on September 20, Farmer Mac wrote a letter to the Comptroller, with the participation of the IBAA and the ABA, requesting that the Comptroller's office treat the Farmer Mac loans on an equal basis with the Fannie Mae and Freddie Mac treatment now.

Mr. NAGLE. Now they are going to be here later, but I thought they'd issued a preliminary ruling or finding and, in fact, you would be treated differently than Fannie Maes or Ginny Maes.

Mr. DICKEY. It is my understanding that up until at least this point that they have not fully resolved the issue within their office as to how the loans would be treated.

Mr. NAGLE. If they treated you as Fannie Maes or Ginny Maes, would that in your judgment be fair?

Mr. DICKEY. Yes, sir.

Mr. NAGLE. Would it in your judgment be financially responsible?

Mr. DICKEY. Yes, sir.

Mr. NAGLE. If you were sitting on this side of the desk, would you recommend that a congressional representative approve a standard that is used on those other two types of loans?

Mr. DICKEY. Yes, sir.

Mr. NAGLE. What happens if they don't? What happens if they set a higher or stricter standard?

Mr. DICKEY. It may restrict the markets somewhat depending upon where they set those limits. If they are too severe, too high of capital requirements, then the smaller community banks will not be able to participate.

Mr. NAGLE. Then we'll be back where we were in 1982 when we started this crazy run the first time won't we? We'll only have one player in the field.

Mr. DICKEY. Yes, sir.

Mr. NAGLE. Thank you.

Mr. ENGLISH. Thank you very much, Mr. Nagle.

Mr. Dickey, Mr. Grove, we appreciate your testimony. Thank you very much.

Mr. DICKEY. Thank you, sir.

Mr. ENGLISH. Our next panel consists of Ms. Dorothy Acosta, Chairperson of the Secondary Market Task Force of the Farm Credit Administration; Mr. John Harman, who is Director of the Food and Agricultural Issues, Resources, Community, and Economic Development Division of the U.S. General Accounting Office; and Mr. Donald Coonley, who is the Chief National Bank Examiner, Office of the Comptroller of the Currency, with the Department of the Treasury.

We appreciate your all testifying before us today. If you would keep in mind what I advised our earlier witnesses. If you would please summarize your testimony, your complete written testimony will be made a part of the record.

Ms. Acosta, we will let you start off.

STATEMENT OF DOROTHY J. ACOSTA, CHAIRPERSON, SECONDARY MARKET TASK FORCE, FARM CREDIT ADMINISTRATION

Ms. ACOSTA. Mr. Chairman and members of the subcommittee, I'm Dorothy Acosta and I'm an attorney with the Farm Credit Administration and serving as Chairperson of the Secondary Market Task Force.

As you know, the Farm Credit Administration is an independent agency in the executive branch responsible for regulating and examining farm credit institutions, of which Farmer Mac is one.

The Agriculture Credit Act of 1987 charges the Farm Credit Administration with the general supervision of the safe and sound performance of the powers, functions, and duties vested in the Federal Agricultural Mortgage Corporation, or Farmer Mac, by that act. I am pleased to be before you today as a representative of the Farm Credit Administration Secondary Market Task Force to discuss the standards recently adopted by Farmer Mac from a safety and soundness perspective.

In the view of the FCA staff, the major risks to the safety and soundness of Farmer Mac lie in the quality of the loans that are generated and sold into the pools, the structure of the securities, and the supporting payment mechanisms. Consequently, we have reviewed the underwriting standards, the appraisal standards and the pool diversification standards with great interest and have commented on these from a safety and soundness perspective to Farmer Mac. My remarks today will reflect in a general way the concerns expressed in our letters, and we will be happy to make those letters available to you if you would like to have them to assist you in your review of the standards.

Mr. ENGLISH. If you would submit copies of those to the committee, please.

Ms. ACOSTA. In our estimation, the underwriting standards adopted by Farmer Mac are very general in nature, and they are subject to exceptions for which the Board has not provided adequate specific limitation. To illustrate this point, standard nine permits the waiver of any standard if the loan demonstrates compensating strengths on one or more of the other standards when such nonconformity and compensating strengths are typical of sound borrowers in the segment of agriculture in which the loan is made.

The FCA staff understands the need for flexibility in agricultural lending and the business realities of developing a market for securities backed by agricultural real estate loans. We are concerned, however, that the failure of the Farmer Mac Board to provide adequate specific limitation on the ability to waive those standards by its management may be unwise, no matter how conservative the intentions and the business instincts of its management. Consequently, we've urged that the Board develop some specific benchmark ratios for various segments of agriculture that would act as an outside limit on exceptions that could be granted under standard nine.

The lack of specificity in the standards also gives rise to a second general concern that Farmer Mac may place too much reliance on market forces and the self-interest of poolers and originators to assure that the standards are in fact met. We are not convinced

that market forces alone can be relied on to ensure that the pools will be composed of sound loans. Our experience with the agency securities market and our contacts with the security rating agencies suggest to us that investors will look primarily to the Government guarantee.

Nor are the we convinced that the self-interest of poolers and originators in protecting their subordinated interests will necessarily provide sufficient assurance of compliance with the standards inasmuch as it is not currently clear whether these subordinated interests will be retained by poolers and originators or whether they may be sold to third parties.

Recently, Mr. Edelman testified, and today again Mr. Edelman testified, that Farmer Mac intends to use a computerized risk analysis, known as a "stress test," which simulates a series of adverse economic scenarios and their impact on a pool of loans. We are very pleased that Farmer Mac intends to use such a "stress test." We would simply urge that in order to ensure meaningful results, that Farmer Mac make certain that the simulation model used is appropriate for agricultural lending. We would also suggest that it may be necessary to require some degree of uniformity in documentation among poolers to produce consistently reliable results.

The eligibility standards we find are also general and refer extensively to the Farmer Mac Securities Guide, which we, of course, have not yet seen. Since they are so general, we are awaiting with great anticipation the publication of the Securities Guide and any standard agreements that Farmer Mac may develop. When those are available, there are some areas that we intend to focus on in our review and I would like to share those with you.

One, the manner in which Farmer Mac will seek to require advances to be made for delinquent payments so that the Farmer Mac guarantee is not triggered prior to the exhaustion of the reserve or the absorption of loss by the subordinated participation interest.

Two, we will be looking carefully at the structure of the subordinated participation interest and the extent to which it provides the equivalent protection of a cash reserve.

Three, we will be looking to see the extent to which Farmer Mac provides for recourse in the event of fraud or malfeasance on the part of poolers or originators.

Four, the extent to which provision is made to ensure that such recourse cannot be defeated if the subordinated interests are subsequently transferred.

Mr. Edelman recently testified that Farmer Mac intends "to let the marketplace and the pooler define security structures and to allow Farmer Mac to test each structure and verify that it works." While we do not dispute the need for flexibility, we would hope that Farmer Mac, at a minimum, would develop some guidelines for structuring securities that would identify some basic requirements or some areas of concern that must be addressed in a manner satisfactory to Farmer Mac.

The capital standards for poolers require that poolers have $2 million in admissible capital and be in compliance with their respective regulators. With respect to this standard, we would simply point out that not all poolers will have the same regulator and, as

you are aware, the capital requirements of various regulators and the components that can be counted toward capital vary significantly among regulators. Thus, there may be an unlevel playing field among poolers with regard to capital required by Farmer Mac.

Since it is unclear how Farmer Mac securities will be structured at this point, it is difficult to comment on the adequacy of the capital standards for poolers because we are unable to tell exactly what the function of capital will be in the pooler. Whatever the function of capital may be in the pooler, however, we would suggest that a $2 million standard that is not related to anything may not be a meaningful measure.

The pool diversification standards we've looked at to evaluate the extent to which they will actually ensure that there is the geographic and commodity diversification intended by Congress. Our analysis indicates that there are at least 30 different scenarios in which the proposed geographic distribution standard might be met which would result in up to 80 percent of a pool portfolio being concentrated in two adjacent States. In many cases, the adjacent States may be subject to the same production and economic conditions. At least seven scenarios are possible in which the entire pool could be concentrated in three adjoining States. In five of these, the entire pool could come from an area within a total radius of only a few miles.

We have encouraged Farmer Mac to develop some further refinement of the pool diversification standards that will ensure that these geographic concentrations do not occur.

In summary, our major concerns from a safety and soundness perspective, at this point at least, are:

One, the lack of specificity in the underwriting and pooler standards and the extent to which management can waive the standards without specific limitation by the Farmer Mac Board;

Two, the absence of a meaningful capital standard for poolers;

Three, the lack of effective monitoring mechanisms and the apparently excessive reliance on market forces and the presumed self-interest of poolers and originators to ensure that the standards are met;

Four, the ineffectiveness of the geographic and commodity diversification standards as they are currently written to ensure that the diversity required by the statute; and

Five, the need for guidelines for structuring securities and agreements that will ensure that the interests of Farmer Mac are protected.

We recognize that many of our concerns may be addressed in the Securities Guide and the standard agreements, but we've not yet seen these documents or a business plan that would reassure us that effective monitoring mechanisms will be implemented. We do understand that Farmer Mac is in a start-up mode and we appreciate the size of the task facing Farmer Mac in gaining market acceptance for this product, but we encourage them to address these problems at the outset so that there will not be significant safety and soundness problems later.

We hope our comments have been helpful. We will be happy to make the letters available to you.

[The prepared statement of Ms. Acosta appears at the conclusion of the hearing.]

Mr. ENGLISH. Mr. Harman.

STATEMENT OF JOHN W. HARMAN, DIRECTOR, FOOD AND AGRICULTURE ISSUES, RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. HARMAN. Mr. Chairman and members of the subcommittee, it is a pleasure for me to be here once again before the committee to talk this time about our recent work concerning issues facing the Congress and the Federal Agricultural Mortgage Corporation as they develop and implement the new secondary market for agricultural real estate and rural housing loans.

We have been working on many issues related to this new market since its early formative stages. Our most recent work focuses on issues and concerns related to Farmer Mac's underwriting and other standards that have been submitted for congressional review. This work was done at the request of the House Banking Subcommittee on Policy Research and Insurance, and the Senate Subcommittee on Agricultural Credit. The testimony I am presenting today for the record and now summarizing, is the same as I presented on September 12 of this year before the Subcommittee on Policy Research and Insurance.

Appendices I through III of that prepared testimony contain issues and questions we raised in our reports during the development and early implementation of Farmer Mac. The appendices also describe risk and risk-bearing mechanisms and strategies in secondary mortgage markets.

I would now like to turn briefly to the three sets of standards that Farmer Mac has submitted to the Congress. Farmer Mac officials told us, and they restated this in their testimony today, that these standards represent the guiding principles for the market's future operations. Farmer Mac will also issue a Securities Guide, as has been mentioned several times, which will contain among other things minimum requirements for various aspects of the Farmer Mac Program and more detailed criteria to guide the market's operation. Farmer Mac is not required to submit the Securities Guide for congressional review. As a result, there is no assurance at this point that some outstanding questions and concerns will be addressed in the guide. Our views today, therefore, are of necessity based on our understanding of the current standards and not on criteria that are not yet formalized or available for review.

Our review of these standards has raised several concerns, many of which have also been raised by the Farm Credit Administration, and questions that the Congress may wish to consider in its review. These concerns have not necessarily been endorsed by potential market participants, but they represent our views formed after having talked to potential participants and others familiar with secondary markets and the farm credit area. One key point to remember in considering our concerns is that agricultural real estate is a new frontier for a national secondary market. The characteristics of agriculture make these loans more diverse and more risky than loans in secondary housing markets. Therefore, many deci-

sions about this new market necessarily will be based on some trial and error, a method that does have some potential risk.

Many of the issues I present in my prepared testimony for the record relate to potential Government risk, and that is GAO's primary concern here. I will briefly discuss four of these concerns, exceptions that are made to standards, the consistency of financial information, standardized market operating agreements, and regulatory implications of the standards. Other areas of concern that we did address in the prepared testimony include concerns about key terms and concepts, financial ratios, pool diversification standards, appraisal standards, and standards for rural housing. In this context, I would like to present our views on the Farmer Mac underwriting standards:

One, it is important to allow for flexibility in loan underwriting standards to react to nonconforming but acceptable situations. We recognize that. However, it is also important that exceptions do not become the rule. Such a case-by-case scenario may not provide the risk protection intended under broader criteria. All three sets of Farmer Mac standards include broad language to allow for exceptions to and/or broader interpretations of the standards.

Two, it is also important that financial information in each loan application be reported in a consistent and comparable manner to better ensure comparable and known risks in the loan pool. Farmer Mac standards do not require use of standardized accounting terms and methods.

Three, a standardized market operating agreement between the lenders and poolers can determine exactly who bears the ultimate risk in the market. Farmer Mac's certified facilities standards are very general in defining the framework for this agreement. For example, the recourse provisions of the subordinated participation interests have not been addressed in the standards. This one element will be a pivotal point that will determine if and when the Government has to provide funds to keep the market afloat in a recession scenario such as agriculture experienced in the early to mid-1980's.

Four, and finally, the potential market participants could be regulated by several different regulators which could result in some participants being regulated more strictly than others. One concern that surfaced during the House Banking Subcommittee's oversight hearings earlier this month is that capital requirements for banks participating in the market may be more stringent than similar requirements for other potential participants, such as insurance companies and the Farm Credit System.

We believe that the concerns that are being raised by us and others need to be considered to ensure that the borrowers being served, market structure, and risk parameters satisfy Congress' broad expectations. As Farmer Mac moves toward meeting these expectations, we believe it has the potential to offer a unique new element to the Nation's agricultural credit delivery network.

I might add also, Mr. Chairman, that we too are awaiting the issuance of the securities guide. Farmer Mac officials have told us that many of our concerns will be addressed in that guide. But at this point, we are operating off the standards that are before us.

We will be glad to answer any questions you may have.

[The prepared statement of Mr. Harman appears at the conclusion of the hearing.]

Mr. ENGLISH. Mr. Coonley.

STATEMENT OF DONALD G. COONLEY, CHIEF NATIONAL BANK EXAMINER, OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEPARTMENT OF THE TREASURY

Mr. COONLEY. Thank you. Mr. Chairman and members of the subcommittee, on behalf of the Office of the Comptroller of the Currency, the OCC, I appreciate this opportunity to present our views on the loan securitization program currently being developed by the Federal Agricultural Mortgage Corporation, Farmer Mac.

We wish to reaffirm our willingness to work with you to reduce the impact of severe economic declines in the agricultural sector on the banking industry and at the same time to help serve the long-term financial needs of farmers. We are actively working with Farmer Mac, the American Bankers Association, and the Independent Bankers Association of America to help develop a sound operational program. Our efforts have resulted in some success.

Mr. Chairman, before I proceed, I wish to explain the basis of the OCC's perspective on the Farmer Mac Program. In our supervisory process, we specifically evaluate the adequacy of the bank's capital and reserve for loan losses. National banks must maintain adequate capital and reserves to absorb loss and minimize the potential for failure of an institution. Ultimately, this reduces the potential risks to the deposit insurance fund. When a bank sells an asset but retains significant risk, the volume of risk does not change. Therefore, the capital and reserve requirements do not change. The events in the thrift industry demonstrate the consequences of a failure of all parties concerned to prudently evaluate risky assets and establish a necessary level of capital and reserves.

The Farmer Mac Program does transfer one type of risk from the banks and has the potential for effectively diversifying additional types of risks in agricultural lending. It also increases the ability of the local financial institutions to provide agricultural customers with long-term financing. In our opinion, however, the opportunity for national banks to participate in the program is being limited by the way certain requirements are being implemented. The problem is a 10 percent subordinated requirement as opposed to a pro rata sharing of risk between all participants.

Farmer Mac requires the company that obtains and puts together the pool of loans—the pooler—to provide a 10 percent subordinated interest in each group of loans supporting the securities guaranteed by Farmer Mac. A 10 percent subordinated interest position means that the company which is in the subordinated position, or second position, is required to absorb the entire first 10 percent of losses that arise. This also means that the company in a subordinated position is the last to be able to collect the funds in foreclosure or liquidation.

The pooler has the option of holding all the subordinated interest or sharing the interest with originating banks. If the pooler holds the subordinated interests, the cost for holding the additional risk will normally be passed on to the originator or to the market. Be-

cause of the interest rate competition and the competition from similar securities in the market, the amount of risk that can be passed on to the market is probably minimal.

The subordinated interest is likely to remain in the bank that originates the loan. The primary credit risk and some of the catastrophic risk are in the bank, with the remainder of the catastrophic risk retained by Farmer Mac. Only the interest rate risk has been moved to the pooler or the market.

Underwriting standards have a direct bearing on the potential for credit risk. While we do not have any objection to the initial underwriting standards, it is important to keep in mind that these are not fixed and are susceptible to market influences. We anticipate that these standards will be relaxed over time if large segments of the agricultural loan market are unable to meet the underwriting standards proposed by Farmer Mac. As credit standards are reduced, the likelihood of default increases. But even if the underwriting standards remain consistently high, there is no assurance that the ability of the borrower to repay will remain stable throughout the life of a long-term loan. Therefore, most of the increased risk from either situation remains in the banking system.

To increase the potential for national bank participation in the program, the disproportionate credit risk must be transferred out of the originating bank or substantially reduced. There are a variety of ways this can be accomplished within the Farmer Mac Program. Any means that accomplishes a pro rata sharing, or some division of the 10 percent subordinated position among the parties, would also reduce the bank's credit risk and hence the amount of capital needed.

The Farmer Mac Program has significant potential, but under the current structure an interested bank is faced with substantial restraint and/or costs with regard to risk diversification, flexibility, lending limit capacity, and capital requirements.

As noted, the Farmer Mac Program provides some benefits. One real benefit is that the long-term interest rate is eliminated for each loan sold into the program. Additionally, the sale of the loan does generate funds that may be used in unrelated investment. This would permit the bank to service the customer and diversify the catastrophic risks somewhat. However, if the banks retains the subordinated position, a number of possible benefits are not realized. Capital cost is not improved and the capacity to lend additional funds to the same borrower is not increased. In that situation, the combination of capital cost, legal lending limit restrictions, and the bank's loss of flexibility to work with the borrower reduces the opportunity for widespread participation in the program by national banks.

Mr. Chairman, we appreciate the opportunity you have afforded us today. We will work with you, the Farmer Mac staff, and the industry groups attempting to formulate a sound method of operation.

[The prepared statement of Mr. Coonley appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you very much.

We have a vote—in fact, the second bell should ring—there it is now. We will recess to make this vote and we will be right back.

[Recess taken.]

Mr. ENGLISH. I want to ask each of you—and Ms. Acosta, I'll start with you—do you consider the underwriting standards for the housing loans to be adequate?

Ms. ACOSTA. The rural housing loans?

Mr. ENGLISH. Yes.

Ms. ACOSTA. We haven't seen what modifications they will make for rural housing loans from the Fannie Mae standards, but we did hear Mr. Edelman testify on September 12, I believe, to some ways in which he intended to modify those. We have not been overly concerned about anything that we heard, let me put it that way. We've not seen them in writing to really look at them, but we have not heard anything that has caused us great heartburn.

Mr. ENGLISH. Mr. Harman.

Mr. HARMAN. We are in pretty much the same position, Mr. Chairman. We have not actually seen the standards and have not had—I do not think—extensive discussions with Farmer Mac on what their standards would be.

As they currently exist, yes, we would have concerns in terms of their specificity, but I think that is something that Farmer Mac is working on and will try to get some more specificity into those standards.

Mr. ENGLISH. Mr. Coonley.

Mr. COONLEY. We have no objection to what we've heard so far.

Mr. ENGLISH. Mr. Coonley, it is my understanding, from discussions you've had with our staff, that generally speaking you consider the underwriting standards to be adequate as far as what Farmer Mac has done. Is that correct?

Mr. COONLEY. Yes, sir. As far as what we know about them, we have no problem with them.

Mr. ENGLISH. If they expand this to include rural economic development loans, do you have any preconceived ideas about what needs to be considered to make sure that those loans are sound?

Mr. COONLEY. In terms of underwriting standards, no. If they use the standard base that any reasonable lender would use, we would be supportive of that.

Mr. ENGLISH. Also, of course, you have I'm sure been listening to the testimony and Mr. Edelman and others have talked about the concerns that they have. It is hard for me to keep from recalling back in 1987 the Treasury Department was not wildly enthusiastic about this legislation when it passed, isn't that true?

Mr. COONLEY. I'm not aware of the Treasury Department's position on it when they were working on it. I can only mention that the period of time that you were working on the Farmer Mac Program was also the time that the international standards were being developed for risk-based capital. There were a lot of things going on at the same time. But I don't have any information in my office of any concerns one way or the other about that legislation at the time.

Mr. ENGLISH. This legislation was not developed along the lines that I think some in the Treasury Department would have liked and so I was wondering whether that in any way was having an influence with regard to the way your office looked at this legislation.

Mr. COONLEY. No, sir. I am not aware of Treasury's interest in this at all. We've worked at it purely from the safety and soundness of the banking system and the Federal Deposit Insurance Fund. I don't know what the issues are in that regard.

Mr. ENGLISH. Do you also take into consideration at all the intent of Congress?

Mr. COONLEY. Oh, yes, sir, very much so. That's why we have worked our very best to try to figure out ways that if the 10 percent subordinated interest were held in the originating bank in its total amount, that this could be dealt with. As I mentioned in the testimony, there has been some progress. The proposal that was sent to us about 1 month ago has some interesting things in it that we're actually working with to see if they would help with the lending limit issue. We haven't received any proposals regarding the capital issues. So we are actively working right now to see if there are ways to work with the lending limit problem.

Mr. ENGLISH. I would hope that these problems can be worked out. I think you can tell the sentiment of this subcommittee. I don't think there is any question as far as Congress was concerned in 1987 as to what was intended. We are in a desperate situation as far as meeting the financial needs of people living in rural areas. I think that the bottom line is that this appears one of the major ways in which we could deal with that, not only from the standpoint of farmers but, as we're expressing here, it may very well be the best source of funding that we have for rural housing and meeting some of the other rural development needs. We're getting into the questions of national priority here. These are directions on which the Congress has spoken and so I would hope that from the regulator standpoint that you all would be creative in finding ways to not only meet the safeguards that you have the responsibility for, which we certainly understand, but to go out of your way to see if that can't be done. I would hope that can be done and done very rapidly.

I appreciate your testimony, Mr. Coonley.

Mr. Coleman.

Mr. COLEMAN. Thank you. Mr. Coonley, I want to ask you a series of questions so that I better understand what the situation is. There are some who say that the treatment by the Comptroller of Farmer Mac is different than Fannie Mae and others. In your testimony you say that a 10 percent subordination that originators or poolers must have is the reason why you're treating them differently than the other corporations. Is that correct?

Mr. COONLEY. No, sir.

Mr. COLEMAN. Do the other corporations have that subordination as well?

Mr. COONLEY. They are starting to do that. When they originally started, they didn't. We are not treating the different programs any differently at this time. When the Farmer Mac Program was first announced we, for accounting purposes, gave them the same treatment that we gave the other federally guaranteed programs. They are shown as moving off the balance sheet for accounting purposes except for that subordinated portion. However, with the risk-based capital standards that are coming into play, both Farmer Mac and other programs which have any subordinated in-

terest or which have any credit risk are going to have to hold capital against that risk.

Mr. COLEMAN. Now let me just stop you there. The other guarantees that you mention also have a 10 percent subordination?

Mr. COONLEY. No, not necessarily. If they do, when risk-based capital standards come into play, they will have to hold capital against that.

Mr. COLEMAN. Well, I'm not asking you about new policies and new future. The law that we passed specifically says that "there shall be a guarantee only if a reserve or retained subordinated participating interest in an amount equal to at least 10 percent of the outstanding principle," and so forth. Is that contained in any of the other guarantee programs that you are talking about?

Mr. COONLEY. I'm not familiar with that provision being in others, but it may well be. In most cases, you buy back the total amount of the loan and everything comes back to the bank. That's usually the way it works.

Mr. COLEMAN. I gather from your testimony that this 10 percent—and you've got it underlined on page 1 and you refer to it all the way through—is the hang-up.

Mr. COONLEY. That is the hang-up, yes, sir.

Mr. COLEMAN. And then you're telling me you are treating them the same as these others but you don't know if the others have that requirement in them or not.

Mr. COONLEY. Before March of this year, we had no way of knowing whether a 10 percent subordinated interest was being taken or not because it was moved completely off the balance sheet. In March, we started gathering that data so we would know whether they had, in fact, done this. If banks take the subordinated interest in these, they do have to hold capital against them in December 1990.

Mr. COLEMAN. If that was not in the act, what would be your problem?

Mr. COONLEY. If the 10 percent subordinated interest was pro rata or was not there, there wouldn't be any problem in terms of banks.

Mr. COLEMAN. There wouldn't be any problems?

Mr. COONLEY. No, sir.

Mr. COLEMAN. So that is the problem.

Mr. COONLEY. That is the problem.

Mr. COLEMAN. Not your new policy, but the problem is the 10 percent.

Mr. COONLEY. Yes, sir, and the risk that goes with it.

Mr. COLEMAN. But at the same time, if we're talking about treating equally or on the same grounds as these other Federal guarantees, it would seem that it would be important to know if those programs also have such a subordination or not.

Mr. COONLEY. That's why we've started gathering the data. But those markets have been around for a long time and they've worked out ways to get around the subordinated interest. They sell off parts; they do a variety of things which Farmer Mac can do as well. I can't categorically state today that there is anybody taking a 10 percent subordinated position in a Fannie Mae or one of those types of loans.

Mr. COLEMAN. You think that the Farmer Mac has that authority today?

Mr. COONLEY. Has authority to what, sir?

Mr. COLEMAN. You just said to sell off its——

Mr. COONLEY. Oh, yes. They could sell subordinated interests out into the market. If they sell a subordinated interest, the bank no longer has to hold capital against it because it is not being held there.

Mr. COLEMAN. Or they could hold less than 10 percent, the banks.

Mr. COONLEY. Or they could hold less than 10 percent.

Mr. COLEMAN. Mr. Chairman, could I ask Mr. Edelman, who has already testified, or his representative to come forward to the table. You've heard my questions and the responses by Mr. Coonley. Is that your understanding of your legal authority?

Mr. EDELMAN. Sir, I think if I could go perhaps beyond the question you are asking, it might be helpful. I think Mr. Coonley's principal concern here is recourse back to the banks and the 10 percent captures that recourse at the bank. Is that a fair statement, Mr. Coonley?

Mr. COONLEY. Yes.

Mr. EDELMAN. There are other programs undeniably, in particular one at Fannie Mae, where the recourse goes back to the bank. For example, a bank swaps mortgages for mortgage-backed securities and in giving the mortgages to Fannie Mae and receiving back mortgage-backed securities, it also gives Fannie Mae 100 percent recourse back to the bank on those mortgages. So that without getting hung up on the 10 percent, the question is recourse versus nonrecourse sales of loans and those transactions, which currently account for approximately 47 percent of the business done by Fannie Mae, are full recourse.

Mr. COLEMAN. Full recourse.

Mr. EDELMAN. And the OCC has no problem with those as true sales not financings. We are seeking that treatment.

Mr. COLEMAN. I think his statement says that since the 10 percent subordination is a full hit and not spread through the whole thing, the banks are actually in a more precarious position under the way this bill is written than under the procedures that are used for Fannie Mae. Is that a fair characterization, Mr. Coonley, of your position?

Mr. COONLEY. It's fair, yes, sir.

Mr. COLEMAN. Which goes back to the 10 percent again. When we drafted this thing everybody was involved with it—the banks, the Treasury Department, and so forth—and there was no objection at the time. Now, Mr. Coonley, in addition to this particular isolated issue, you wanted to say a while ago, and I'll let you say again, that the Department is reviewing standards on all of these programs.

Mr. COONLEY. Yes, because of the risk-based capital requirement that comes in place in December 1990. We gave a specific exception originally to the mortgage loans. We have not come out and said anything about treating Farmer Mac any differently at this point. But it obviously is going to come into the decision process of the bank because they know in December 1990 they are going to have

to have capital against that risk, as against these swaps that Mr. Edelman talked about.

Mr. COLEMAN. And that policy in December 1990 is one initiated by the Comptroller or by some congressional mandate or law?

Mr. COONLEY. They are international standards that were agreed to about 1 year ago by all of the regulatory agencies internationally. The seven major countries came together and came to an agreement so you could have an equalized playing field in terms of how much capital is required. How we apply those capital standards, we do have flexibility in. The reason for the risk-based capital standards is so that you require the amount of capital necessary for the risk being taken. That's all that happens here. So the more risk that gets left in the bank, the more capital they are going to have to hold against it. That's the bottom line.

Mr. COLEMAN. And what Mr. Edelman describes as a customary, at least 40 percent customary in normal procedures, is really going to run into some deep trouble when your December 1990 new risk base capital standards go into effect.

Mr. COONLEY. They will face the same issue, except I think with the one he's describing, a lot of the stuff comes back with it including the collateral and all that. If that happens, the risk will be adjusted accordingly. But in the same circumstances, the same standards will apply.

Mr. COLEMAN. I think that what you're telling me is that perhaps meetings—are these the Paris meetings?

Mr. COONLEY. Yes, sir. Let me correct that response. No, sir, the meetings were held in Basel, Switzerland, not Paris.

Mr. COLEMAN. The Basel, Switzerland meetings with the seven nations at the highest level are somehow impinging on little old Farmer Mac out here that's struggling to get going. This is really news.

Mr. COONLEY. No, sir. We have been concerned about risk being missed as part of the capital requirement anyway. In an individual bank situation, regardless of what these standards said, if we saw an inordinate amount of risk on a balance sheet anytime, we would have asked for more capital. We would have required it on an individual bank basis regardless of what kind of program they were involved in. So if you had a bank taking these second positions in a variety of loans on their balance sheet, we would have been demanding capital or reserves regardless of any international agreement or anything else because the safety and soundness of the system is affected and the potential for failure of a bank is at stake here.

Mr. COLEMAN. When the bill was passed and all of this was happening, we didn't know what was going to transpire at the Basel meeting, we didn't know what the new policies were going to be, and now you are applying—because this is the new one coming along—you are applying these standards that everybody is eventually going to live under early on to this particular corporation.

Mr. COONLEY. We have not applied those standards to Farmer Mac at this point. We have accorded them similar treatment at this point. They have asked for an active statement from us saying that they are going to get that treatment. So far, we've said take it

off the balance sheet as you do everything else, but we haven't said across the board you can treat them the same way.

Mr. COLEMAN. And when are you planning on doing that?

Mr. COONLEY. So far we have not made that decision. We got the letter from Mr. Edelman asking for that specific treatment on September 21, just 3 or 4 days ago. The other issue of the lending limit we have been looking at and have been making progress on. But the capital issue still remains.

Mr. COLEMAN. I hope that you will work with the guarantee corporation and the lending institutions and the people involved with this thing. If they have to come back in December 1990 like everybody else and these things are all applied across the board, then I think we have less to complain about. But you should let them go forward. I think it is a little bit of a breech of faith when your people were helping draft this bill at the time and now you come back and apply a new policy. When you get to December, fine, everybody plays by the same rules. All they want to do is go into that equal to the rest of them.

Mr. COONLEY. Could I make two points, sir?

Mr. COLEMAN. Sure.

Mr. COONLEY. First of all, whether we apply the standards today or not, any bank making the decision has to know what kind of capital they are going to be called on to have on hand in December 1990 because these are long-term loans. I don't know that our stance is going to make any difference on that anyway.

I'd like for just 1 minute to mention what kind of risk we're talking about here because a bank's survival is pretty important in these communities. A bank has an opportunity—through leveraging—selling off up to 125 times their capital and maintaining on their books the 10 percent of what they've sold off. In that 10 percent is all the credit risk, which we've been advised is around 3 percent, 3 percent to 5 percent are the numbers I've heard. Accepting the smallest amount of that, 3 percent, if you have 1 million in capital and you've made these loans for that, you've got a 30 percent chance of risk of loss in those loans that you've maintained because now you have the first 10 percent, that's the problem. If I sold $100,000, I kept $10,000 on my books. There is a historical loss rate, an average loss rate of all those loans of 30 percent—$3,000 because it is against $100,000. I've got to take the first hit so there is a good chance I'm going to lose $3,000. That's 30 percent of that loan. Now, to ask a bank to hold minimum capital against that kind of risk isn't going to be prudent banking. There is an example on page 6 of my prepared statement.

[The material follows:]

Therefore, because the bank would continue to hold the credit risk, it will need capital to offset the potential risk. For example, the bank makes a $1,000 loan and historical risk is estimated at 3 percent or $30—historical risk is based on the bank's estimate that all loans of this type have lost and will lose $30 per $1,000 on average. The bank sells the loan and retains the 10 percent subordinated interest.

Having sold $900 of the loan, they now have a $100 balance on the books. But, because they retain all of the first 10 percent risk of loss from the whole loan, the bank still retains the $30 historical risk. The historical risk is not 30 percent of the bank's balance on the loan as opposed to the original 3 percent.

Mr. COONLEY. Second, an examiner looking at a loan that has the potential loss rate of 30 percent in it is probably going to classify

that loan as a substandard asset in the bank, and perhaps even a doubtful asset in the bank, on any loan that has that kind of risk. Then you add on to that that when this loan goes bad, if it goes bad, you are not going to get any of that money back because the 90 percent is going to eat up all the collateral.

In listening to Mr. Edelman's testimony, he has assured you that there aren't going to be any Government funds at risk here. In talking about the subordinated interest and in terms of the underwriting standards being used, somebody is at risk, and what I'm saying to you, sir, is that it is whoever holds that 10 percent subordinated interest that is at risk. If it is in the bank, then they are going to have to hold capital against that risk. I do agree that most of the catastrophic risk has been moved to Farmer Mac.

One final statement. There are a variety of ways that this can be worked out, it seems to me, that enable everybody to walk away from here where you feel comfortable about the banking system and you are providing the lending to the agriculture community. We want national banks to participate in the program. We want them to diversify the risk in their assets. So we will work very hard to do this. We're not standing in the way through any selfish purposes here.

Mr. COLEMAN. Would that be through increasing their underwriting standards that we heard about today and so forth?

Mr. COONLEY. If they increase their underwriting standards, it makes the loans safer, but they are still long-term loans, and you don't know how that's going to work out over a 25-year period. As long as they use reasonable underwriting standards and as long as economic conditions remain stable where they are, then you can use minimum capital standards against the risks that are there. As the underwriting standards go down or as the economic conditions worsen, then you start increasing the amount of reserves that you want banks to hold against that potential risk. Over time things get adjusted.

Mr. COLEMAN. Mr. Edelman, while you're there, this 10 percent subordinated interest, if that were to be eliminated or be reduced down or something like that, how does that affect your operation?

Mr. EDELMAN. It would be a question of who would hold the 10 percent. If you're saying that the statute could be changed so that Farmer Mac could accept the notion of a lower percentage than 10 percent, what it would basically do would be permit us to evaluate what would be the appropriate level of subordination as well as the quality of loans on a pool by pool basis. As it is right now, we intend to evaluate the appropriateness of 10 percent minimum subordination or reserves. So it would help us but it wouldn't entirely solve the problem. I think we would still be facing in large measure the problem that if you took it down to 4 percent, it is a fair guess that Mr. Coonley would still say that 4 percent required 100 percent of the original principal of the loans to be considered the starting point for the calculation of the risk base capital analysis.

Mr. COLEMAN. Well, it doesn't sound like we're resolving this. Mr. Coonley, are you the one personally who is doing the discussion, the negotiation with the Treasury?

Mr. COONLEY. Yes, but we have other people involved—I misspoke, there are no negotiations with the Treasury. We have legal

staff and we have other examining staff reviewing the issues, and I talk often to Mr. Clarke personally about it. His charge to us is to try to work out a solution to it. That's what we're trying to do.

Mr. COLEMAN. I hope that's successful and I hope that people are working in good faith to try to accomplish that.

Thank you.

Mr. ENGLISH. Mr. Nagle

Mr. NAGLE. I don't want to beat the same line. I've reviewed your testimony. Treasury had a great deal of difficulty with this proposal when we started out. You don't think the Treasury would purposely be writing the rules so that the program won't work and banks can't participate to win a legislative victory they couldn't in the Congress. That wouldn't be the case here, is it?

Mr. COONLEY. I have not had any contact with Treasury, sir. I have no idea what position they took or why they took it. I'm just looking at the safety and soundness of the banking system. No one from Treasury has talked to me at all.

Mr. NAGLE. Justify the proposed higher standard here as opposed to Ginny Maes or Fannie Maes.

Mr. COONLEY. There is not a higher standard being applied at this time.

Mr. NAGLE. I kind of get the impression though that you're drifting that way.

Mr. COONLEY. I couldn't say categorically one way or the other on that. At this point, we don't have any plan to issue any statement saying yea or nay, but we are going to respond to Mr. Edelman's request and in that we may be put in a position where we are. It is almost moot because of the 1990 standards coming in place and, therefore, may not be a problem at this point. They wouldn't have been able to put on enough to ruin the system or the bank by 1990. So we don't have any plans to treat it any differently at this point, no, sir.

Mr. NAGLE. I was one of the original sponsors of the creation of a secondary mortgage market. Members of this committee, the House of Representatives, and the U.S. Senate felt that it was important that we introduce two concepts into the land, rural America. One was that there be a competitive system for long-term land lending; and second, that the result be that lower interest rates would drop the farmer's cost, and as a result of that, the necessity of farmers relying on Government price supports would be lessened because the cost would be lowered going into it.

Regulations that are adopted to defeat the purpose of Congress undoubtedly would cause me to immediately introduce legislation for consideration by my colleagues to restore the congressional intent, which is that we have a working broad-based secondary mortgage market. I am disappointed in what I'm hearing OCC is doing because it seems to me to be directly in opposition to the intent of this Congress if the standards are as unworkable as I'm being advised that the current concept under consideration is.

Mr. COONLEY. I guess I haven't been able to explain it quite clearly enough. What we're talking about here in the first place is only those types of situations where the bank decides to hold the first 10 percent. There are a variety of other ways that they can remove this risk.

I would also say, sir, that only 22 percent of the agriculture banks in the country are national banks. Only 28 percent of the total agricultural loans in agricultural banks are national bank loans.

Mr. NAGLE. One of the reasons of that percentage is because of the fact that under the old system only the Federal Land Bank was in a position to make those long-term loans. We're trying to change those ratios with this bill. But if regulations prohibit that change——

Mr. COONLEY. My point, sir, is that national banks only make up a small portion of this and there are other banks involved here. What I am proposing to you today is not a unique capital requirement for this kind of risk for just national banks. I have not been able to adequately explain the risk here and why capital is required.

Mr. NAGLE. No. And the 10 percent requirement in essence forces banks to make the loan, then sell the loan, and then you lose the local contact because they become totally divorced from the process. That causes us concern in rural America from the borrower's standpoint. That would be another impediment to the effectiveness of the system. You are throwing out the baby with the bath if you stick on that 10 percent requirement.

Mr. COONLEY. On the other hand, sir, if between the pooler and the banker and perhaps the investor in some way they pro rate this 10 percent out, that would reduce the amount of capital or reserves that a bank had to hold against this exposure as well.

Mr. NAGLE. I know you are in the process of drafting your regulations and I would only encourage you to take into consideration my remarks and what I perceive to be the intent of the Congress, as one of the original cosponsors of the legislation, and to draft regulations that are financially sound but also make it work. If you would do that, I'd appreciate it.

Mr. COONLEY. That's our intent.

Mr. ENGLISH. We thank you all and appreciate your testimony today.

Our last panel is Mr. James Parrish, vice president and associate director of Moody's Investors Service in New York, and along with Mr. Parrish we will have Mr. Frederick Medero, who is vice president, asset and Government finance, Kidder, Peabody & Co., Inc., in New York. We want to welcome you both.

Mr. Parrish, we will let you lead off, if you would please. We want to remind you, as we have our other witnesses, to please feel free--in fact, we would urge you—to summarize your testimony and we will make sure your complete written testimony is a part of the record.

STATEMENT OF JAMES A. PARRISH, VICE PRESIDENT AND ASSOCIATE DIRECTOR, MOODY'S INVESTORS SERVICE

Mr. PARRISH. Mr. Chairman and members of the subcommittee, my name is James A. Parrish. I am a vice president and associate director of Moody's Investors Service in New York. I appreciate this opportunity to provide you with Moody's thoughts on the credit risk associated with the establishment of the Federal Agri-

cultural Mortgage Corporation, or Farmer Mac. Specifically, I will address the risks we see in the underwriting standards for both loan diversification and appraisals, as well as the eligibility standards for certified facilities or poolers. I will also give you Moody's perspective on the likely market acceptance of securities that carry the Farmer Mac guarantee.

First, I'd like to give you a brief overview of Moody's and of our structured finance group. Founded in New York at the turn of the century by John Moody, Moody's Investors Service has been rating the credit worthiness of debt securities since 1909. Today, we rate well over 40,000 corporate and government debt securities worldwide. In the process, our analysts follow more than 3,000 issuers of debt ranging from sovereign nations and financial institutions to industrial enterprises. We also rate the credit risk of several thousand structured finance issues, which is the area I am representing today.

As you are probably aware, structured finance is a fast growing and increasingly complex form of debt financing. Essentially, it involves the packaging of financial assets for resale in the credit markets as debt securities. Traditionally, most structured financings were securities backed by home mortgages; but today structured financings may include the repackaging of asset types that range from commercial mortgages to automobile loans and even corporate bonds. The securities themselves may be offered to investors in a wide variety of structures—including bonds, pass-throughs, and other securities such as those that will be guaranteed by Farmer Mac.

In evaluating the credit risk of structured securities we call upon the analytical expertise of industry experts throughout Moody's to assess not only the potential default risk of the assets backing the security but also the risks inherent in each particular security's cash-flow and legal structure.

Given that introduction, let me speak first to the proposed underwriting standards for Farmer Mac. One approach to addressing those standards would be to go point by point in evaluating the criteria presented in the proposed guidelines. However, Moody's does not ascribe to a formula-driven approach to credit analysis. Perhaps the best way to describe our approach would be to outline how Moody's evaluated a recent $365 million vendee loan sale by the Veterans Administration. In assessing all such financings, Moody's uses a building block approach that combines quantitative rigor and qualitative judgment. In the VA sale, our approach included an evaluation of:

One, the underlying assets, which are the vendee loans;

Two, the practice and procedures of the originator, the seller, and the servicer;

Three, the structure of the security, that is, the priority of its cash distributions, its credit support, and so forth and;

Four, the legal risks.

We based our evaluation of the vendee assets on more than 3½ years of quantitative analysis of historical default and delinquency data on more than 8 million conventional and Government residential loans. The data studied, which includes the experience of the private mortgage insurers, the FHA, the VA, and the Mortgage

Bankers Association, dates from the early 1970's and also includes statistics from the Great Depression. The results of this analysis were combined with expectations about geographic regions, industries, and certain economic forecasts to predict the probable future performance of pooled assets. In rating the VA sale, Moody's findings were applied to the specific pool characteristics and to the delinquency and default statistics of the vendee loans to quantitatively assess the expected losses on the portfolio.

Next, a team of analysts visited the loan origination and servicing facilities to evaluate the operations and the ability of management to service the loans going forward. The findings of these meetings were reviewed by the rating committee and incorporated into the projection for future portfolio losses.

We then focused on the deal's structure. In this case, the VA chose a structure similar to that proposed for Farmer Mac securities, whereby the pool of loans is divided into senior and subordinate portions. Approximately 50 percent of the VA portfolio was subordinated to protect investors from incurring default losses on the senior AAA-rated securities.

A statistical method was used to determine the credit quality of the rated securities. In addition, the receipt and distributions of monthly cash-flows were examined to determine whether third-party bankruptcies and insolvencies could have an impact on the quality of the rated securities.

Finally, the legal nature of the issue was reviewed to assure that the rights of the senior certificate holders would not be impaired by other claiming ownership interests in the underlying vendee loans. Moody's then combined the results of the quantitative analysis of the pool and structure along with the qualitative assessment of the originator and servicer and the legal nature to determine the individual credit strength of the structured security.

Now, what I've just described is an application of Moody's general approach to credit analysis—a combination of empirical analysis and judgment. We suggest that Farmer Mac employ a similar strategy in assessing the credit quality of the underlying agricultural loans and the structural strength and legal risks of the securities to be offered to investors.

In doing this, the first step Farmer Mac should take is to analyze the historical pattern and magnitude of losses for agricultural mortgage loans. This process will involve developing a comprehensive data base of delinquencies, defaults, and recoveries for these loans. Using this data base, Farmer Mac should then identify the important factors that cause losses and use this information to create a model that can project future losses. Two points should be noted here: One, not all of these factors can be quantified in a statistical model, and two, all the factors that affect losses should be projected into the future.

For example, in Farmer Mac's case, they must project regional, national, and international economic conditions to assess the future worldwide demand for specific agricultural products. Political considerations both here and abroad should be factored in, particularly farm trade and subsidy policies. The effect of changes in consumer tastes, such as shifts toward a preference for naturally produced goods, should be weighed. The impact of innovations in

technology should also be considered as should the effects of recent weather patterns worldwide.

In other words, as we at Moody's have found, simply relying on the historical data to predict the future is a somewhat tenuous proposition. Instead, the historical data should be used as a base and then adjusted to reflect an assessment of the current and probable future conditions that could devalue the underlying collateral. This requires the use of reasoned judgment tempered by experience.

We have also found that the pool-specific characteristics that determine credit losses cannot be captured by a rigid pass-fail, formula-driven approach. A thorough evaluation by Farmer Mac would require an evaluation of the financial strength of the seller/servicer and on-site operational reviews to assess origination, appraisal, and servicing procedures. Additional attention should also be paid to the adequacy of the servicer's computer backup systems and its ability to provide accurate investor reports. In addition, Farmer Mac must diligently monitor originator and servicer practices to ensure continued adherence to its standards.

However, even if Farmer Mac uses its best judgement to adjust historical loss numbers, other factors should be considered. Credit analysts must recognize that even their best guess regarding portfolio losses is only that—a guess. Therefore, an evaluation of how variable the outcomes can be is essential to determining how much exposure Farmer Mac has to credit losses.

To evaluate the potential variability of losses on a pool of loans, it is necessary to assess first, the variability of the forces that affect the value of the underlying collateral and, second, the diversity of the collateral. Diversity should be evaluated along many lines, including the number of loans in the pool and the concentrations of geographic locations, crops produced, raw materials used, and export markets.

Once the expected loss and variability of a pool are determined, it is necessary to combine these measures and the required credit support into a single assessment of the adequacy of the credit support level. What I am speaking to you here is simply from Farmer Mac's perspective, the perspective of the taxpayer putting up the $1.5 billion of credit enhancement. I'm not speaking to the perspective of the bank and the financial adequacy or financial condition of the bank itself.

Finally, if Farmer Mac guaranteed securities are to establish a viable secondary market, they must be attractive to prospective originators and investors. In order to participate in this market, originators must have an incentive to originate and sell loan product into the Farmer Mac Program. This requires economically efficient credit support levels. In other words, the proper balance must be struck between the first loss position taken by the sellers of the loans and the protection that credit enhancement provides to Farmer Mac and the taxpayers. Furthermore, the attractiveness of pooling loans to meet the Farmer Mac guarantee requirements will depend on the availability and flexibility of pooling entities as well as the evolving regulatory, accounting, and tax issues. For instance, bank capital constraints may discourage institutions from holding subordinate interests in Farmer Mac guaranteed securities.

For investors, the attractiveness of the program depends on their confidence in Farmer Mac's ability to manage the complex credit risks that are involved. That confidence will depend on the extent to which Farmer Mac can implement a judicious evaluation process such as the one described earlier. Also, the availability—real or otherwise—of U.S. Government support beyond the $1.5 billion will affect investor perception of the credit risk.

In summary, I have described the process by which Moody's analyzes structured financings similar to those that will be guaranteed under the Farmer Mac Program. I have also presented you with specific recommendations on how Farmer Mac might evaluate the securities it will be guaranteeing. These include:

One, employing a rigorous statistical analysis to determine the historical loss experience on agricultural loans;

Two, evaluating the many factors that affect the value of the underlying collateral, including economic, environmental, political, and technological conditions; and

Three, carefully analyzing the pool-specific characteristics as well as legal and structural risks.

In addition, I outlined some of the considerations that will affect the market acceptance of the Farmer Mac securities.

By way of closing, let me say that Farmer Mac has a formidable task before it. Moody's has found that credit analysis cannot be strictly quantified, nor can it rely solely on a matrix of inflexible standards, nor can it be described precisely by a formula. Instead, prudent evaluation of credit risk must also encompass a qualitative assessment by the analyst. The final evaluation must incorporate analysis, experience, and judgment.

Thank you for the opportunity to share these thoughts with you.

[The prepared statement of Mr. Parrish appears at the conclusion of the hearing.]

Mr. ENGLISH. Mr. Medero.

STATEMENT OF FREDERICK R. MEDERO, VICE PRESIDENT, ASSET AND GOVERNMENT FINANCE, KIDDER, PEABODY & CO., INC.

Mr. MEDERO. Thank you very much, Mr. Chairman. My name is Fred Medero. I am a vice president with Kidder, Peabody & Co., Inc. in New York. I appreciate the opportunity to be here today and to present this testimony. Thank you and Mr. Coleman, the ranking minority member of the subcommittee, for this opportunity.

We are particularly pleased that the committee has called the hearing for a review of the Farmer Mac Program. We think it shows the interest in the progress that Farmer Mac has made to date. It shows the commitment to the legislative purposes and to the objectives that you mentioned before in terms of the Farmer Mac Program. Hopefully, and we think it will, affirm the wisdom of the subcommittee and of the Congress in setting up the Farmer Mac Program when it passed the Farm Credit Act Amendments of 1987.

I'd like to go through and try to summarize my testimony for you rather than reading the statement. As I mentioned in the state-

ment, Kidder, Peabody has long been involved in the securities markets. We've been in business for over 120 years as investment bankers to a variety of clients. The area of the firm in which I'm engaged is called asset finance and government finance, and Kidder, Peabody has been on the leading edge of applying securitization technology to asset receivables, Government asset sales, and project leasing. Most notably, we have served as financial advisor to the Farmers Home Administration in connection with their rural housing loan sale, the 502 Program, and to the Veterans Administration in connection with their vendee loan sales.

Kidder, Peabody strongly supports the Farmer Mac Program. We believe that the technology of securitization and the creation of related secondary markets for loan assets has enormous potential for introducing many of the concepts of financial management to the process by which the Government finances itself and for program improvements. I have a particularly strong interest in Farmer Mac, having worked on the legislation as a member of the Senate staff back in 1987 and 1988.

In terms of Farmer Mac, Kidder, Peabody believes that our intimate knowledge of the Farmer Mac Program and the related issues, combined with our direct experience in successfully resolving similar structural problems, gives us a rather unique ability to add value to the efforts of poolers and originators to use the Farmer Mac Program to better serve their farmer-borrowers. What I would like to do is go through the brief observations highlighted in my statement and to add perhaps a couple of points to each one.

First, we believe that if allowed to evolve based on comparable market dynamics and disciplines, there is every reason to expect that Farmer Mac will achieve success in the agricultural area parallel to that achieved by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation in the residential real estate mortgage area.

Both Fannie Mae and Freddie Mac have been successful in creating liquidity in the secondary market for residential mortgages. The results of that are better rates and more widely available credit for homeowners and an effective means by which financial institutions can sell off interest rate risk that investors, such as pension funds, are better equipped to deal with.

Fannie Mae and Freddie Mac are market-driven organizations, which is one of the main reasons why they are so enormously successful. I would make the same case for Farmer Mac. Those who Congress has charged with monitoring the process should avoid the temptation to second-guess and engage in "shadow management" of Farmer Mac. Rather, if they will allow the market to work, Farmer Mac can be just as successful as Fannie Mae and Freddie Mac. The big winners in all of this will be the farmers, ranchers, and rural residents that Congress intended to benefit by the Farmer Mac Program.

Next, if Farmer Mac originators and poolers are permitted to work out the details of this program at the retail and wholesale level, obligations backed by agricultural and rural residential mortgages guaranteed by Farmer Mac can be competitive. The agreements between originators and poolers must be the product of business bargains. While Farmer Mac can have a limited role in seeing

that the parties are treated fairly and deal with each other fairly, the parties must be able to negotiate agreement provisions that protect their respective interest. Originators and poolers can and will find the products that appeal to farmers and ranchers and at the same time provide the best price to the market. This is, after all, the means by which credit services are expanded and competition for the farmer's business is encouraged.

Next, Farmer Mac has drawn underwriting standards that accommodate various types of agricultural production operations. Those standards are sufficiently specific to allow originators and poolers to focus lending activity with a view toward pooling loans under the Farmer Mac Program. Congress can be confident about the underwriting standards that Farmer Mac has adopted, and the open and public method by which those standards were developed. I would like to emphasize two points:

One, the standards accommodate all types of agriculture, and there has been real direct input from farmers and ranchers through their respective trade associations; and

Two, suggestions that recently enacted thrift appraisal standards be adopted by Farmer Mac should turn on an evaluation of their real value for this particular program. The respective problems recently experienced in the thrift and agricultural finance industries were very different. The solutions, such as the appraisal standards that had been suggested, may have some, but not universal applicability.

Next, Farmer Mac's underwriting standards, when combined with the geographic and diversity standards that have been adopted by Farmer Mac, reflect a dynamic rather than a static approach to risk management. Those standards will be applied on a by-pool, not just on a by-loan basis. Farmer Mac has wisely reserved the flexibility necessary to adjust certain of those requirements to assure that their application does not unfairly work against certain agricultural areas or commodities.

The risk both to poolers, who have the first loss position, and to Farmer Mac, if there is a catastrophic loss, is based on the strength of the loan pool not just the individual loans in the pool. Farmer Mac understands this and has indicated that it will deal with this in a way that will assure the successful risk management that it must engage in.

Next, there will be adequate opportunity after the first few deals are completed by Farmer Mac for interested parties, including Congress, to review the process, develop constructive criticisms, and make any appropriate adjustments for future transactions. Any exposure to the Treasury in the interim from those transactions will be minimal. The requirements for SEC registration and review will assure that the terms of the transactions are both well documented and disclosed to the public.

Next, the performance to date of the Farmer Mac Board of Directors and management demonstrates professionalism and competence, and argues for affording those individuals every opportunity to continue to prove themselves and the workability of the secondary market program that Congress sponsored. The people involved, including the farmers and ranchers on the Board, have earned the right to proceed and make this program successful. Farmer Mac

understands the need to get information on the program out into rural communities, to farmers, to ranchers, and particularly to rural bankers who want to participate in the program, but perhaps don't completely understand its applicability and how some of the problems are being worked out.

Next, the focus should be on establishing a climate that encourages institutions that are willing to accept eligibility criteria and ongoing responsibility for loan pools to enter the market as Farmer Mac poolers. We believe that the economics of the market will determine what the ultimate number of poolers should be.

Next, a concern which has a been a principle focus of this hearing—the regulatory concerns. We believe that regulatory treatment of subordinated interests retained in securitized loans and loan pools threatens participation of banks in the Farmer Mac Program. As those guidelines would presently be applied, no recognition would be given for the substantial credit and interest risk reduction that would accrue to a bank from securitization using the Farmer Mac Program, as compared to the risk on agricultural and real estate credit extended outside the program. The goal of encouraging banks to use the secondary market to reduce risk and to serve farmers and ranchers will be frustrated absent flexibility on the part of the regulators.

This is one of the critical issues to the success of Farmer Mac in expanding credit to farmers through the rural bank delivery system. The primary regulators of commercial banks and FSC institutions can either make the program by recognizing the benefits for risk management, or break the program in terms of participation by banking institutions by taking an inflexible position on the related issues. This is not an issue for Farmer Mac to resolve, but for the regulators of Farmer Mac stockholders to resolve in Farmer Mac.

Mr. Chairman, I have two letters that Kidder, Peabody has written to the regulators—one to Mr. Michael Shephard at the Comptroller of the Currency's Office, and one to Mr. John LaWare, a Governor of the Federal Reserve Board—outlining what we believe are possible solutions to the capital problem. I would ask, Mr. Chairman, that those letters be made a part of the record, with your permission.

Mr. ENGLISH. Without objection, so ordered.

Mr. MEDERO. In our letter we acknowledged the fact that every asset on the balance sheet which is not cash or a Treasury security needs to be supported by capital. I don't think anybody who has testified today has contradicted that. The real issue is what category of capital Farmer Mac subordinated interest should be dropped into. Under the Comptroller's current interpretation, they would be placed into what's called the "100 percent category." We've outlined a number of reasons, and Mr. Dickey pointed to some of the reasons in his testimony, why we think that these subordinated interests should be placed into a lower category.

Our suggestion is a "30-percent category." I think you heard the representative from the Comptroller of the Currency say that he thought there was 3 percent risk overall in a farm loan portfolio. We think that the 30-percent category that we've suggested corresponds more accurately to what the real risk is in those portfolios.

We have also suggested that in placing these retained subordinated interests into a lower category, that the regulator do it for a 5-year period. As you know, the Farm Credit Administration has capital regulations which require farm credit institutions to come up to a capital level of, I believe, 7 percent. They have given farm credit institutions a 5-year period within which to reach that 7 percent level. We have suggested that Farmer Mac would be an excellent way for commercial banks and Farm Credit System institutions to get rid of a lot of the interest rate and credit risk that is on their balance sheets. If the 30 percent capital provisions were applied for a 5-year period, it would give the Comptroller, the FCA, and the Federal Reserve Board an opportunity to see just how these loan pools perform. We think that, based on that data, they will find that loans that are put into these pools perform substantially better than loans that are made outside the underwriting guidelines. In any event, at the end of that period, the regulators can go back and take a look at the situation with respect to capital and adjust that capital requirement based on real data, rather than on some speculation as to what the losses may be or can be. We have made this the last point of our suggestion in the letters to the regulators.

Finally, the farmers and ranchers whom Farmer Mac was intended to serve remain very positive and enthusiastic about the potential for this program. However, if enthusiasm for the secondary market is to be maintained and the intentions of Congress fulfilled, Farmer Mac should be encouraged to be in a position to guarantee the first issues of obligations backed by agricultural mortgages by the end of 1989.

Much has been done to date, but success will not come until the first few deals are completed.

Each quarter that goes by without Farmer Mac being operational means another season that farmers are denied the chance to benefit from the program. Financial institutions that are anticipating Farmer Mac being operational may be making unsafe interest rate risks by offering 30 year, fixed rate mortgages without the ability to properly match those mortgage assets. Without Farmer Mac up and running, Congress may see a repeat of the crisis already experienced in farm credit. Even worse, it may see the playing out of an agricultural version of the savings and loan crisis, with all of the attendant harm to farmers and taxpayers. Farmer Mac needs to be in place so there is no reason for financial institutions to be taking unnecessary duration risks.

Mr. Chairman, I thank you again for the opportunity to make these remarks and to present this testimony. I would be pleased to try to answer any questions that you might like to pose.

[The prepared statement of Mr. Medero appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you very much, Mr. Medero. I don't have any questions for either you or Mr. Parrish. I just want to tell you how much I appreciate your testimony. It was a fine statement. Thank you both very much.

We will recess subject to the call of the Chair.

[Whereupon, at 1:20 p.m., the subcommittee adjourned, to reconvene at the call of the Chair.]

[Material submitted for inclusion in the record follows:]

FEDERAL AGRICULTURAL MORTGAGE CORPORATION

"Farmer Mac"

Statement of

Henry D. Edelman, President and CEO

to the

Conservation, Credit and Rural Development Subcommittee

of the

Committee on Agriculture

of the

United States House of Representatives

September 27, 1989

INTRODUCTION

Mr. Chairman, distinguished members of the Subcommittee, it is a pleasure to appear before this Subcommittee to report on the progress and direction of the Federal Agricultural Mortgage Corporation -- commonly known as "Farmer Mac." My name is Henry D. Edelman, and I am the President and Chief Executive Officer of Farmer Mac. It is an honor to appear before this Subcommittee to discuss the financial means by which Farmer Mac expects to deliver the statutorily-intended benefits to the farmers and ranchers of this Nation.

Less than two years ago, the members of this subcommittee were in the middle of legislative deliberations of enormous importance to agriculture. Faced with an agricultural credit crisis of unparalleled proportions, you played a critical role in the crafting of the Agricultural Credit Act of 1987. You determined that more efficient financing of loans for agricultural real estate and rural housing were essential to the resolution of that crisis. Thus, the creation of a new secondary market for agricultural real estate and rural housing mortgages was made a part of that Act, to better secure the economic well-being American farmers and ranchers throughout this country.

The near-term credit picture for agriculture has changed in a very positive way since 1987. Still, if we are to improve the longer term view for agricultural credit, I believe the basic objectives of that Act must be pursued. Farmers and ranchers who are running sound businesses need -- and deserve -- the availability of long-term credit at stable interest rates, from lenders with greater liquidity and lending capacity. Access to the efficiencies of capital market funding translates to availability of lower-cost funding. So long as that access is not readily available to all who are genuinely interested in extending credit to farmers and ranchers and rural homeowners, those who do have such access may only price to meet the competition of those who do not. Notwithstanding the

improved condition of the agricultural credit sector, increased liquidity, interest rate risk asset-liability management techniques, uniform credit standards and new financial products are needed for the continued viability of all who extend credit to agriculture.

As Congress contemplated in 1987, the Farmer Mac program will be critical to meeting these needs. With sound credit underwriting, loan repayment, security appraisal and diversification standards in place, Farmer Mac will be able to deliver to agricultural and rural housing borrowers those benefits the secondary markets have for so many years provided to urban residential borrowers. Farmer Mac cannot be limited to only the highest quality credits that exist in agriculture. By the same token, Farmer Mac cannot be a lender of last resort, supporting weak producers. We must, and will, operate in a manner that extends program benefits to a wide range of financially sound agricultural producers and rural homeowners, without exposing the government to significant risk of loss.

From the producer's perspective, the secondary market will soon present both near term benefits and long term opportunities. Farmers will gain immediate access to new sources of long term credit and an increasingly efficient and competitive lending environment. New products, such as long-term fixed rate loans, will be available. Community banks will benefit from the development of Farmer Mac's uniform credit underwriting and other standards, increased liquidity and -- most of all -- from the immediate opportunity to spread interest rate and credit risks that are very difficult for lenders to predict and manage.

While I have so much positive news for your Subcommittee today, I cannot be blind to a few negative issues worthy only of brief dismissal. First, concerns have been voiced over the relationship that will exist between originating banks and the borrowers after

loans are sold. The truth is that it will be in the mutual interest of all parties involved in Farmer Mac-guaranteed transactions to perpetuate existing customer relationships. This is the best way to minimize losses to all interested parties and, logically enough, it is just what investors really want. Second, there has been some apprehension about the nature of the relationships that might exist between originating banks and poolers. Farmer Mac will, as stated in the Eligibility Standards for Certified Facilities, require that all contracts governing the relationships between poolers and originators be filed with our office. While we will not act to approve or disapprove such contracts in the ordinary course, we intend to review those contracts in light of our requirement that "certified facilities shall be fair and reasonable in the relationships they establish with originators." Moreover, Farmer Mac commits to investigate promptly each bona fide complaint of a breach of that requirement by any party or proposed party to such contracts, both at the time of contracting and throughout the life of the relationship. We are confident that our extended discussions with the principal proponents of these concerns have satisfied them, and would be pleased to provide you with additional information in that regard.

Before I proceed further, Mr. Chairman, I want to outline the contents of this statement and emphasize our objectives. Farmer Mac presents a very exciting opportunity for farmers, ranchers and those interested in the future of agricultural real estate and rural housing. The testimony you will hear from these groups will demonstrate a high level of consensus and support for what Farmer Mac has been striving to accomplish. The key to our approach has been to provide a source of new and better financing for long term fixed rate loans to those borrowers considered good credits by responsible agricultural lenders. This approach should permit Farmer Mac to succeed as a financial institution without precluding the majority of farmers and ranchers from participation in our programs.

My testimony today will focus on the critical issues that we believe go to the very heart of Farmer Mac's operation and success during the next few months. I will address: (1) qualified agricultural and rural housing loans under Farmer Mac; (2) the structure of the Farmer Mac program; (3) the senior/subordinated structure of Farmer Mac-guaranteed securities; (4) the development and synergistic character of the standards; (5) the multi-step dynamic process for assembling and evaluating loan pools for a Farmer Mac guarantee; and (6) specific major issues that have been identified and deserve individual response.

When my testimony is completed, I am confident you will conclude that both the Interim Board and the Permanent Board of Farmer Mac, proceeding in a manner that will not raise a significant risk of Farmer Mac using its Treasury "backstop," have acted with the utmost responsibility and with all deliberate speed to increase the availability of stable, long-term credit to agricultural borrowers and rural home purchasers and provide greater lending capacity to lenders for those borrowers.

PROGRAM OVERVIEW

First, I would like to recap briefly where we have been. As you know, Farmer Mac was created by Title VIII of the Farm Credit Act of 1971, as amended by the Agricultural Credit Act of 1987 (the Act) in January 1988. In accordance with the Act, President Reagan appointed the nine-member Interim Board of Directors of Farmer Mac in May 1988. The Interim Board arranged for the sale of Farmer Mac's common stock in November 1988, in which I acted as financial advisor. (A copy of the Offering Circular for the stock issue is included as Exhibit A hereto.) The stock sale, in turn, created stockholders who were able to elect the Permanent Board of Directors (the "Permanent Board") of Farmer Mac in

March 1989. (A copy of the Proxy Statement is included as Exhibit B hereto.) As required by the Act, Farmer Mac established Eligibility Standards for Certified Facilities -- commonly known as "poolers" -- and submitted its Credit Underwriting, Loan Repayment and Security Appraisal Standards to Congress on June 30, 1989, 120 days after the Permanent Board's first meeting. Farmer Mac's Loan Diversification Standards were submitted to Congress on July 18, 1989. (Copies of all these standards are attached as Exhibits C, D and E hereto.) The following other relevant Farmer Mac documents are included as Exhibits F through I, respectively: 1988 Annual Report; 1988 Financial Statements; 1989 First Quarter Report and 1989 Second Quarter Report.

Farmer Mac, as constituted by the Act, represents an important innovation from the pattern of existing Government-Sponsored Enterprises (GSEs). Although it will function much like the Federal Home Loan Mortgage Corporation (FHLMC) and the Federal National Mortgage Association (FNMA), it is engaged in a line of business familiar to the private sector capital markets. Functionally, Farmer Mac will be closely analogous to a number of specialized participants in the capital markets, known as "mono-line bond insurers" (bond insurers). We are accordingly structuring Farmer Mac's operations to resemble those of the bond insurers in many respects. This means that, before Farmer Mac places its guarantee on <u>any</u> pool of loans, it will not only ascertain that the loans conform to its various standards, but will also run an industry-standard computerized risk analysis of the pool.

Farmer Mac has worked in conjunction with consultants from an independent public accounting firm that has in-depth experience with computerized risk analysis techniques routinely used by bond insurers. Those techniques, known as a "stress test," simulate a series of adverse economic scenarios and their impact on a pool of loans.

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Utilizing historical data from agricultural loans made during the period 1965-1988, we have tested the validity and reliability of our standards by using them as the primary screening device in a series of special runs of our stress test. The detailed analyses made on that basis have demonstrated to us that loans conforming to our standards, used as collateral for the issuance of Farmer Mac-guaranteed senior securities in accordance with the statute, should result in no guarantee payments by Farmer Mac in excess of guarantee fees received.

QUALIFIED LOANS

Farmer Mac has been established to benefit borrowers and lenders in the agricultural and rural sectors of the United States by facilitating the financing of real estate through improved access to the capital markets. The loans that will qualify under this program are described as follows.

1. AGRICULTURAL REAL ESTATE LOANS

Throughout the legislative deliberation on the Act, the primary focus of the House and Senate Agriculture Committees was to facilitate the financing of agricultural real estate to meet the continuing needs of farmers and ranchers for an adequate source of credit on flexible terms and at competitive rates of interest. Real estate is the largest single area of capital commitment for most producers. Farmers and ranchers have not had the benefits of an active secondary market similar to the secondary markets in existence for residential mortgages. Under the Act, a loan is qualified for inclusion in a Farmer Mac pool if it is an obligation secured by a first mortgage on land, or a building affixed to

land, that is used for the production of one or more agricultural commodities or products.

Additional conditions specified in the Act essentially limit eligible Farmer Mac borrowers to United States citizens and legal aliens, as well as certain domestic businesses and other entities. Further, agricultural mortgage loans will be required to meet credit underwriting, loan repayment, security appraisal and loan diversity standards to qualify for inclusion in a Farmer Mac pool.

2. RURAL HOUSING LOANS

In addition to the primary objective of facilitating the efficient financing of farm land, Congress recognized the need to provide rural residents greater access to residential mortgage financing, and provided for access to the Farmer Mac secondary market for rural housing loans. This could have significant benefits for home financing in small communities across the nation. Currently, most rural housing is excluded from the secondary market programs operated by FNMA or FHLMC because of typical characteristics which do not conform to the standards applicable to those programs. We have specifically designed the Farmer Mac program to accommodate pools of rural housing loans. This approach is in accordance with Congressional intent and is consistent with current rural development initiatives under consideration by the Administration and in Congress.

Under the Act, a rural housing loan is qualified if it is a first mortgage obligation on a single-family dwelling used as the principal residence of the borrower, with a value not exceeding $100,000 (adjusted for inflation since the enactment of the Act) and located in a rural area or community of 2,500 or fewer inhabitants.

In developing standards for qualified rural housing loans for inclusion in a Farmer Mac pool, we have taken advantage of the experience of FNMA by adopting most of its underwriting standards. However, the FNMA standards, which are common industry norms for residential mortgages eligible for sale in the secondary markets, have been modified to eliminate the limitations normally imposed upon rural housing loans. The FNMA property exceptions for rural housing mortgages that will be considered for inclusion by Farmer Mac in rural housing loan pools are set forth in Schedule I attached to this statement. Certain limitations will be applicable to rural housing loans under the Farmer Mac program, such as the required 75 percent loan to value ratio and the property value limitation as specified in the Act. Our preliminary analyses give us clear indications of the stability of housing ownership in rural communities, the elements of real estate valuation in those communities and the critical void in available financing for rural housing. We believe that permitting the property excluded from the FNMA program into the Farmer Mac program will ensure those homeowners access to the secondary market without undue risk of losses to the pools or to Farmer Mac.

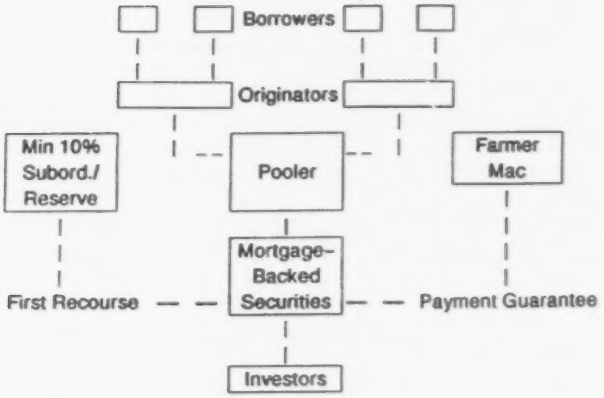
The benefits of this increased financing will extend to the rural communities served as well as to the lending institutions which provide rural housing loans. Of course, rural housing pools will be subject to the same evaluation process as agricultural loan pools to assure that these pools demonstrate the same integrity and soundness.

HOW THE FARMER MAC MARKET WILL OPERATE

Turning to how the Farmer Mac market will operate, it is useful to view the process diagrammatically. The figure below shows the steps involved in originating "qualified

loans" through the issuance of Farmer Mac-guaranteed mortgage-backed securities.

HOW FARMER MAC WORKS



Farmer Mac-guaranteed securities begin with the extension of loans to farmers and ranchers and other eligible borrowers. A borrower will most likely shop among Farmer Mac originators in his local area to find a loan with the terms that best suit his particular needs and credit position. He will apply to a participating lender ("originator") for a loan secured by collateral that is defined as "permissible" under the Act. This includes: (a) land of a certain minimum acreage and maximum value or acreage, used for the production of agricultural commodities or products and (b) single-family residences in rural areas.

An originator may be any Farm Credit System institution or a "bank, insurance company, business and industrial development company, savings and loan association,

association of agricultural producers, agricultural cooperative, commercial finance company, trust company, credit union, or other entity that originates and services agricultural mortgage loans." Minimum voting common stock ownership requirements for originators has been established by Farmer Mac's Board of Directors. (See Schedule II.)

Originators will be responsible for the extension of approved loans to qualified borrowers. In reviewing a loan for approval, the originator must underwrite the borrower's credit and appraise the property pursuant to standards established by Farmer Mac. Upon approval of the loan by the originator, the borrower will place a mortgage on the collateral. The loan will be further documented by the originator using documentation that conforms to Farmer Mac standard representations and warranties. The result will be a "qualified loan" that the originator may sell to a pooler for use as collateral against which Farmer Mac-guaranteed securities may be issued. Farmer Mac itself will not originate or pool any loans under the program, thus, it will not be in competition with originators. This structure will facilitate additional lending by Farm Credit System institutions as well as community banks and other traditional agricultural lenders.

Much as borrowers may shop among competing originators for the best loan terms, so also originators may shop among competing poolers for the best terms of sale for their qualified loans. Originators may retain the servicing of the loans and an interest in the cash reserves or subordinated securities created in connection with the securitization of the loans. These will be points of negotiation between originators and poolers, though the Act provides that originators "shall be permitted to retain" the right to service their loans.

A Farmer Mac pooler, formally designated a "Certified Facility," must meet the same criteria as originators, as well as certain other criteria currently or hereafter

established by Farmer Mac. Under the Act, a pooler must be "an institution of the Farm Credit System or a corporation, association, or trust" organized under federal or state law. One of its purposes must be the sale or resale of securities representing interests in, or obligations backed by, pools of loans qualified under the Farmer Mac program. Poolers will be required to comply with criteria set by Farmer Mac, including: (1) maintaining minimum capital of $2 million; (2) adopting appropriate loan underwriting, security appraisal and loss servicing standards; (3) demonstrating managerial ability with respect to agricultural mortgage loan underwriting, servicing and marketing; (4) establishing acceptable procedures for loan administration and disclosure to borrowers concerning the terms and rights applicable to the Farmer Mac program; and (5) permitting periodic audits by Farmer Mac of its books and records relating to its pooling and securitization activities. In addition to these statutory criteria, there is a 5,000-share minimum Farmer Mac voting common stock ownership requirement for poolers. To ensure the safety and soundness of poolers and the integrity of the pooling process, Farmer Mac will continuously monitor the poolers and require pooler recertification at least every five years.

POOL SECURITIZATION

It is anticipated that origination, pooling and securitization of Farmer Mac-qualified loans will follow existing practices in the mortgage-backed securities market, subject to the special procedures previously outlined. Poolers will pool qualified loans and issue senior securities backed by those pools, supported by some combination of cash reserves and subordinated securities. The senior securities will carry Farmer Mac's guarantee of timely payment of principal and interest.

Under the Act, Farmer Mac-guaranteed securities will have to be "registered" under the Securities Act of 1933. This will require filing with the Securities and Exchange Commission (the "SEC") a "prospectus" containing specific disclosures about the issuer (the pooler or its subsidiary) and the underlying loans, as well as a description of the nature of Farmer Mac's guarantee. Although the SEC has agreed to review these filings on an expedited basis, it is too early to say whether this will satisfy poolers who must assume market risk during the review period.

SECURITY STRUCTURES

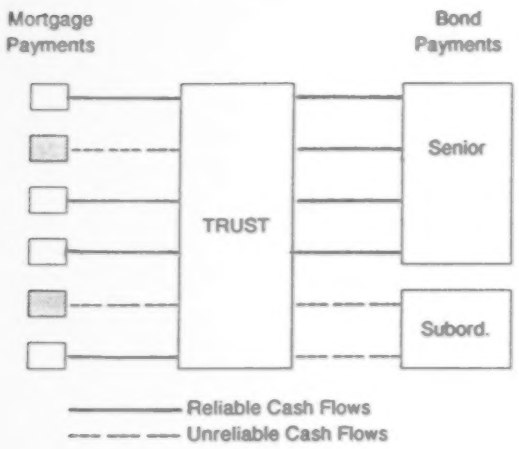
It was recognized by the Congress that the qualified loans for pools of securities guaranteed by Farmer Mac would be eligible for favorable tax treatment as Real Estate Mortgage Investment Conduits (REMICs). The REMIC security has brought enormous benefits to the residential mortgage market through such securities issued by FNMA and the Federal Home Loan Mortgage Corporation (FHLMC) in the billions of dollars. A unique characteristic of the REMIC security is the diversity of the form of security which may be issued to meet the changing needs of markets and investors.

The Act creating Farmer Mac contains broad authority for the guarantee of securities by Farmer Mac. To satisfy investor demands for the most efficient security, Farmer Mac will not attempt to limit the form of security structure eligible for its guarantee. It is critical to the success of Farmer Mac-guaranteed securities in the capital markets that the structure of these securities should utilize the broad statutory authority and have the flexibility to meet ever-changing market requirements.

The essence of a senior/subordinated structure is internal credit enhancement by

allocation of interests in loan payments instead of individual loans. Within any pool of loans, many individual loans will be reliable, but some will be unreliable. By issuing senior securities against whichever loan payments in a pool actually prove to be reliable, it becomes unnecessary to identify in advance the individual loans that will be reliable. The following diagram illustrates this concept.

SENIOR/SUBORDINATED STRUCTURE



In fact, this structure also corresponds to the roles assumed by the participants in the transaction. Originators generate mortgage loans, most of which will generate reliable loan payments, indicated by white boxes and solid lines, but under stress some may generate less reliable loan payments, indicated by shaded boxes and broken lines,. The pooler will typically form a trust that acts as a collector and filter for those loan payments in the senior/subordinated structure. The reliable loan payments will be allocated to the

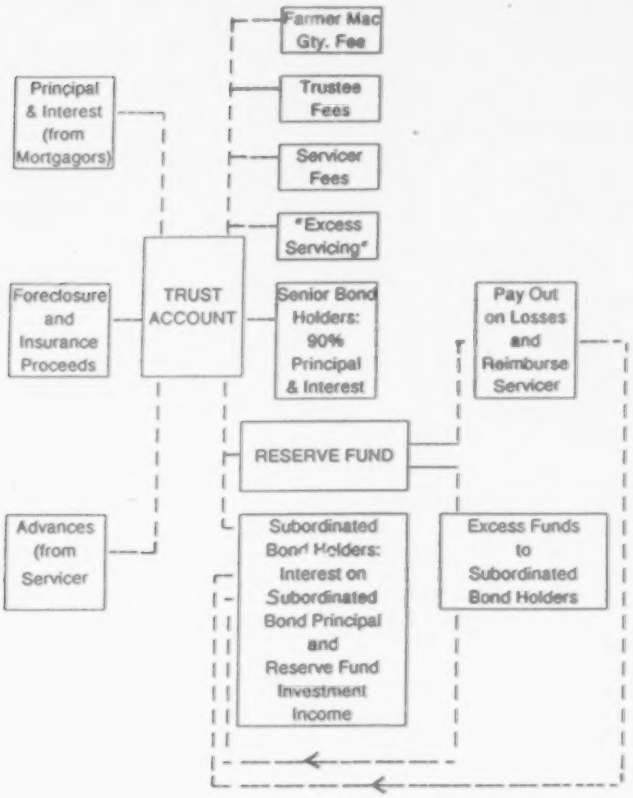
investors who are senior security holders, and the less reliable loan payments will be allocated to those who are subordinated security holders.

Structures relying exclusively on cash reserves are possible. To the extent cash reserves are used, securities that would otherwise have been subordinated may be issued with a Farmer Mac guarantee. The drawback inherent in this structure, however, is the certain loss ("negative spread") implied by the difference between the yield on the securities and the almost invariably lower yield derived from reinvestment of the cash reserves.

Many security structures still require some level of liquidity reserves. Loan servicers will make short-term advances to cover any delinquencies (30 to 60 days) that occur; however they will expect these to be repaid from a liquidity reserve. To achieve this, some senior/subordinated structures start with small cash reserves that are initially funded by loan payments that otherwise would have been paid to subordinated security holders. Once the cash reserves are adequately funded, they are held at that level for several years, then allowed to diminish as a constant percent of the steadily declining outstanding principal amount of the loans. On the other hand, a "shifting interest" structure often pays senior security holders in full in advance of principal payments to subordinated security holders.

The following diagram illustrates the payment priorities in a typical senior/subordinated structure. The flow of payments illustrated is from left to right and the priority of payments is from top to bottom.

SENIOR/SUBORDINATED PAYMENT PRIORITIES


Farmer Mac Gty. Fee
Principal & Interest (from Mortgagors)
Trustee Fees
Servicer Fees
"Excess Servicing"
Foreclosure and Insurance Proceeds
TRUST ACCOUNT
Senior Bond Holders: 90% Principal & Interest
Pay Out on Losses and Reimburse Servicer
RESERVE FUND
Advances (from Servicer
Subordinated Bond Holders: Interest on Subordinated Bond Principal and Reserve Fund Investment Income
Excess Funds to Subordinated Bond Holders

The relative merits of subordinated securities and cash reserves will have to be determined on a pool-by-pool basis. While reserves do permit the issuance of larger Farmer Mac-guaranteed security classes, as mentioned previously, reserves create a "negative spread" problem. And, while subordinated securities may eventually be salable, it will be more difficult to sell interests in cash reserves.

The form of the security structure will be determined by the make-up of each pool and the segment of the investment population that has been targeted for the sale of the securities. This process does not lend itself to the constraints of a hypothetical generic subordination agreement. However, each structure can be verified as achieving the desired goal for pool losses to be adequately covered by the subordinated securities. We believe that the most efficient and effective approach for Farmer Mac to is to let the market place and poolers define the securities structures and for Farmer Mac then to test each structure and verify that it works.

THE FARMER MAC GUARANTEE

Farmer Mac will guarantee timely payment of principal and interest on securities that represent no more than the most reliable 90% of the loan payments generated by pools of qualified loans formed by poolers. To be eligible for the guarantee, the pool must be composed of loans that meet Farmer Mac's credit underwriting, loan repayment, security appraisal and diversification standards. Farmer Mac is authorized by the Act to charge poolers an annual fee of up to 1/2% of the outstanding principal balance of each guaranteed pool. Farmer Mac's financial integrity -- and, hence, the strength of its guarantee -- will be supported by four key elements: (1) the reserve and subordination requirements, which will be verified from pool to pool, depending upon pool and security characteristics; (2) initial and annual guarantee fees; (3) its loss reserves and equity, derived from its initial offering of voting common stock, as well as any subsequent issuance of equity or debt securities and retained earnings; and (4) after the reserves and subordinated interest in a pool -- and its own loss reserves and equity -- have been exhausted, Farmer Mac ultimately may issue up to $1.5 billion of debt to the U.S. Treasury

to fulfill its guarantee obligations. Of course, it is the intention of Farmer Mac never to draw upon the line to Treasury.

Farmer Mac's principal protection from guarantee losses will come from the enforcement of its standards and its determination, on a pool-by-pool basis, of the level of cash reserves or subordinated securities necessary in a transaction to obtain its guarantee on the senior securities. It would be difficult, perhaps impossible, to achieve this result through guarantee fee variations, within existing statutory limitations.

HOW FARMER MAC DEVELOPED ITS STANDARDS

The Act requires Farmer Mac to establish credit underwriting, security appraisal and loan repayment standards for loans to be pooled in Farmer Mac-related pools; diversification standards governing the composition of each pool to reduce the risks incurred by Farmer Mac in providing guarantees; and standards for the certification of poolers. Congress provided certain requirements relating to each set of standards and required that Farmer Mac submit its proposed credit underwriting, security appraisal and loan repayment standards to Congress within 120 days after the election of the Permanent Board and that Farmer Mac submit its proposed pool diversification standards to Congress. Congress also provided that Farmer Mac issue its standards for the certification of poolers within 120 days after the election of the Permanent Board. Farmer Mac has complied with all these statutory mandates.

Late in the summer of 1988, the Interim Board appointed several task forces, chaired by its own members, to begin developing recommended requirements for loan underwriting, appraisal and eligibility of certified facilities. These steps were taken to

enable the Permanent Board to begin considering those standards as soon as possible after its election. Experts from a variety of Farmer Mac constituent groups, including community banks, large commercial banks, insurance companies and the Farm Credit System, were included on each of the task forces. The Permanent Board, seated in March 1989, did in fact continue to use these task forces.

The Credit Underwriting and Security Appraisal task forces each produced a discussion draft of their standards. Recognizing the importance of practical comments from Farmer Mac's constituents, those discussion drafts were made a part of the Farmer Mac 1989 First Quarter Report and distributed to stockholders and other interested parties for review and comment in April 1989. We held a public forum to receive oral comments from interested parties in May 1989. The Board members who chaired the task forces and the members of the task forces attended and participated in the public forum. Interested stockholders, lenders, farmers, ranchers, consumer groups and government agencies submitted written statements on the standards and participated in panel discussions at the forum. The written submissions and the transcript of the public forum were reviewed with the Board at its May 1989 meeting. Revised standards were approved by the Board at its June 1989 meeting. Farmer Mac submitted the revised "Credit Underwriting, Loan Repayment and Security Appraisal Standards" to Congress on June 30, 1989, within the statutory time frame of 120 days after the Permanent Board's first meeting.

The Certified Facilities task force formulated a discussion draft of Eligibility Standards for certified facilities, commonly known as "poolers." That draft was circulated to shareholders and other interested parties in early June 1989. These proposed standards were discussed in a public forum held later the same month, at which Farmer Mac again received useful practical comments. Many of these were incorporated in the final version

of the "Eligibility Standards for Certified Facilities (Poolers)," established by the Permanent Board on June 30, 1989, consistent with the same statutory time frame mentioned earlier.

The Loan Diversification Standards task force worked with an outside consulting firm with expertise in agricultural statistics and economics to assist it in formulating an approach to diversification of agricultural economic risk. With that expert assistance, this task force formulated the "Loan Diversification Standards" that were approved by the Board and submitted to Congress on July 18, 1989.

During the months of July and August, after the standards had been submitted to Congress for review, a number of questions were raised by the Independent Bankers Association of America regarding the interpretation and intent of certain provisions. The Farmer Mac Board and management considered the resolution of these concerns, as well as other questions raised by various interested groups and individuals, as meriting high priority attention. Every effort was made to fully discuss these issues and identify solutions acceptable to all parties involved in the program. I am very pleased to report that these efforts were successful. Each issue has been resolved without the need of making any change in the language of the standards themselves. Attached to this statement as Exhibits J and K, are two important letters documenting the understanding between Farmer Mac and the IBAA on the issues raised by that association.

CREDIT UNDERWRITING AND LOAN REPAYMENT STANDARDS

Farmer Mac has adopted nine Credit Underwriting and Loan Repayment Standards in all. The first eight reflect the general profile of a sound agricultural borrower. These

include credit application and financial statement requirements; a debt-to-asset ratio; a total debt coverage ratio for the borrower; a debt coverage ratio for the financing; a current ratio; a loan to appraisal value ("LTV") ratio; a debt service ratio; loan repayment parameters; and incorporate underwriting standards of FNMA, adjusted to reflect the usual and customary characteristics of rural housing.

Farmer Mac's ninth Credit Underwriting Standard was added in response to concerns that sound borrowers in certain segments of agriculture conform to credit profiles other than our general profile. Therefore, this standard provides that Farmer Mac may, on a pool-by-pool basis, accept loans that do not conform to all eight of the other standards if two conditions are met. The non-conforming loans must consistently exceed one or more of the standards with which they do conform, and they must be made to producers of particular agricultural commodities or products for whom such a credit profile typifies a sound borrower. Farmer Mac will require that this be convincingly demonstrated, most likely by reference to a historical record of high-quality loans to borrowers who meet the proposed commodity-specific profile.

Considered collectively, these standards make provisions for a broad range of agricultural borrowers, regardless of the commodity they produce, to qualify for financing under the Farmer Mac program. Consistent with Congressional intent, these standards will allow loans into program of such quality as to meet substantially and generally the purchase standards imposed by private mortgage securities investors without undue risk exposure to government. However, the standards will accommodate both large and small agricultural borrowers so long as they are financially sound credits.

APPRAISAL STANDARDS

The Appraisal Standards task force sought to accomplish two purposes. Aware of the wide variance of backgrounds of appraisers currently used by community banks and Farm Credit System banks throughout the country, this task force sought not to exclude a significant portion of the qualified mortgages from the Farmer Mac program by setting specific qualifications for appraisers used by originators. At the same time, in an effort to achieve uniform quality, specific qualifications were set for appraisers used by certified facilities (poolers), with the intent that poolers should review the appraisals submitted to them for uniform quality. The standards provide for reliable appraisals of collateral for Farmer Mac loans which recognizes actual circumstances confronting potential originators in connection with the availability of qualified agricultural real estate appraisers in different regions of the country. The second objective was to rely upon an existing set of standards for agricultural real estate appraisals. The Uniform Standards of Professional Appraisal Practice (USPAP) were used for this purpose, with the permission of the Appraisal Foundation.

The Appraisal Standards relate to appraiser selection, qualifications and proficiency (with the distinction mentioned earlier for appraisers for originators and appraisers for certified facilities); definition of appraisal terms; contents of the appraisal report; and currency (age) of the appraisal. In addition to the Appraisal Foundation's explanatory comments to its standards, there are specific Farmer Mac interpretive comments. With respect to rural housing, the FNMA "Property and Appraisal Guidelines" were adopted, with certain exceptions appropriate to rural housing as mentioned earlier.

POOL DIVERSIFICATION STANDARDS

Particular emphasis was placed on the Pool Diversification Standards, because of the benefits that should be achievable by managing geographic and commodity risks. These standards focus on minimizing risks confronting individual originators within a diversified subset of the agricultural sector, rather than on those posed by individual borrowers. The Pool Diversification Standards task force approached the formulation of these standards with several objectives. First, strong emphasis was placed on the importance of complying with the statutory requirements. Second, recognition was given to the importance of keeping regional poolers viable in the program and optimizing pooler competition. Third, the standards were designed to be able to evolve predictably over time, to ensure that they continue to reflect a well-balanced risk among agricultural commodities.

All specific statutory requirements were adopted as written; this is reflected in standards nos. 4, 5 and 6. In the case of standard no. 5, the Farmers Home Administration definition of related borrowers was adopted by way of clarification.

In order to achieve wide variation in the initial principal amount of loans, a requirement was included that 5% by principal amount of each pool be composed of loans under $100,000. The language of the Act's general requirement as to size was also included to ensure that loans not be concentrated at the two ends of the size distribution spectrum.

It was found that the U.S. Department of Agriculture's ten geographic regions which are used in connection with much of the Departments economic and financial data collection and analysis, made the most sense in terms of grouping states by commodities,

weather and natural risks. Several alternative formulations of acceptable minimum groupings of regions were considered, such as the use of non-contiguous regions. However, it became apparent that either the requirement would have to be so complex and difficult to achieve that it would discourage pooler participation, or that almost any reasonable requirement could be defeated through deliberate concentration. This led to the conclusion that the requirement should be for loans in a pool to be originated from at least three of the USDA regions, with the caveat that Farmer Mac "reserves the right to reject any pool that does not comply with the spirit of this standard." While this is aimed particularly at loan concentration around the several three-way convergences of those regions, it is also directed to pools that do not show a reasonable level of dispersion of loans within each of their included regions, regardless of number.

Several approaches to commodity diversification were considered. The final method of measurement chosen was gross revenue attributable to a commodity, based on the combination of cash receipts and government payments. Because farm revenue data is readily available is determined in the market place, it does not need to be imputed. This was determined to be the best surrogate for the ability of producers of each commodity to service their loans, although it was acknowledged that the production of some commodities is more capital intensive than others.

Related commodities were grouped into sixteen categories (listed in Exhibit E). A statistical analysis was made and confirmed that the economics of these categories were highly independent of one another, based on USDA data since 1965. The "concentration" of each of these groups in the national totals was calculated, and the groups were refined so that each represented neither too small nor too large a percentage of the total national revenues from all groups. It was determined that a concentration of up to three times the

national level would permit pools to be formed on a regional basis without creating excessive exposure to any one commodity. This was further refined by imposing a 40% cap on the acceptable level of any commodity in a pool. Also, a provision was made for periodic revisions to the acceptable concentration levels for all commodities, based on shifts in national production patterns over time.

SYNERGY AMONG FARMER MAC STANDARDS

Farmer Mac has formulated credit underwriting, loan repayment, security appraisal, and loan diversification standards that work interactively to produce pools that should result in ultimate losses of less than 10% in "worst-case" economic scenarios. While no single standard would be sufficient to screen out all losses, they were designed to work interactively to achieve this result. This approach is made viable as a risk management technique when it is recognized as the screening phase in pool formation. A pool that passes this initial screen must then pass our stress test by demonstrating that Farmer Mac should not be required to make guarantee payments beyond its guarantee fee income in the "worst case" economic scenario. Although we have written our standards to achieve such a result with 10% subordination, it has always been Farmer Mac's position that it will also evaluate pools individually.

Several further observations should be made about Credit Underwriting standard no. 9. The interaction between this standard and Loan Diversification standard no. 3, which requires commodity diversification, will result in a limitation on the number of loans in a pool that may qualify for any commodity-specific credit profile. The commodity-specific profile must be able to withstand the "worst case" scenario in the

Farmer Mac stress test which, in turn, focuses on economic downturns related to commodities as well as geographical areas. Finally, originators and poolers who formulate the proposed exceptions will have to live with the long-term economic consequences of holding or selling the securities. We believe these very significant constraints on the use of Credit Underwriting standard no. 9 will limit Farmer Mac's exposure to loss while facilitating the desired flexibility.

DYNAMIC EVALUATION OF FARMER MAC POOLS

The legislative history of the Act is clear that the Congress intended that Farmer Mac undertake its secondary market responsibilities in the most efficient manner. There are repeated references to the secondary markets created by the other privately-operated agencies, Fannie Mae and Freddie Mac. In determining the most effective method of providing its guarantee to pools of qualified loans, Farmer Mac is following the practices of these other secondary market agencies which have a proven track record. Rather than rely solely upon the credit underwriting, appraisal and pool diversification standards, Farmer Mac will examine each pool in its totality to determine that the senior securities guaranteed by Farmer Mac are adequately protected.

It has long been the stated intent of Farmer Mac to go beyond its standards in evaluating each loan pool. While we have heard concerns expressed to the effect that our standards might not be sufficient to protect Farmer Mac in every instance, these comments appear to be based on the assumption that Farmer Mac would perform only "static evaluations" of the pools. That evaluation method would permit the formation of pools of loans that merely pass a set of standards, as would be typical of many "entitlement" programs now

administered by Government agencies. If Farmer Mac were to attempt to operate on that basis, it could never adequately protect itself from abuse, short of adopting standards that exclude loans from the majority of the borrowers and financial institutions it was intended to benefit. Rather, we have followed the intent of the Act and organized Farmer Mac to perform what I shall refer to as "dynamic evaluations" of the pools.

In the beginning of my testimony, I noted the significance of the statutory requirement that Farmer Mac issue its guarantee only upon securities credit enhanced by either an unguaranteed subordinated class of securities issued against the same collateral, or cash reserves. This led Farmer Mac early on to the conclusion that, regardless of the standards it would set for credit underwriting, loan repayment, security appraisal, or loan diversification, further analysis of each pool would be necessary to ensure that potential losses in an economic stress situation would not exceed the level of subordination or reserves supporting each pool. In this regard, the Offering Circular for the initial public offering of Farmer Mac Class A and Class B Units, dated November 23, 1988 (p. 23), expressly stated:

> *Reserves and Subordinated Interests.* . . . The Interim Board will recommend to the Permanent Board that each Certified Facility be required to establish Reserves for, or retain Subordinated Interests in, each pool equal to at least 10% of the Pool, the amount thereof to be determined by Farmer Mac on a Pool-by-Pool basis in accordance with guidelines to be established by the Permanent Board. The Interim Board will also recommend to the Permanent Board that it develop guidelines for establishing minimum amounts that incorporate factors similar to those used by nationally recognized rating agencies and bond insurers for rating mortgage-backed securities. (Emphasis added.)

Using this dynamic evaluation approach, Farmer Mac always has the right to reject a pool, to require restructuring of a pool, or to require greater than 10% reserves or subordination for a pool that is economically weak, even though its loans comply with all of our standards. Participants in the capital markets who work with the rating agencies

and bond insurers have long accepted dynamic evaluation of pools. It is in the interest of Farmer Mac, its stockholders, the Government and the sound borrowers and lenders who seek to benefit from securitization of agricultural real estate and rural housing mortgages that we also take this approach, and we intend to do so.

REGULATORY ISSUES OF CONCERN TO FARMER MAC

As an important part of the start-up of Farmer Mac, we are working with a number of federal agencies that have authority over Farmer Mac and the institutions that will participate in its program. Several regulatory issues have arisen and are being actively monitored and addressed. In addition, Farmer Mac is working with the two federal agencies that have regulatory and review responsibilities for its operations to facilitate their procedures.

Office of the Comptroller of the Currency (OCC) - There are three issues of particular concern to Farmer Mac currently under consideration by the OCC. It should be noted that the first issue will be a parallel concern at the other members of the Federal Financial Institutions Examination Council (FFIEC), particularly the Federal Deposit Insurance Corporation and the Federal Reserve Board.

Risk Retention by National Banks. The treatment of the retention of a Farmer Mac subordinated interest in connection with the sale of loans into a pool as a sale of assets with recourse under OCC risk-based capital guidelines is an issue of tremendous importance to Farmer Mac. The OCC staff's current position on the issue would result in the selling bank being required to hold capital against the

entire loan, as opposed to only against the retained interest. The OCC is treating the lending limits restriction and risk-based capital guidelines as one issue -- risk retention by national banks. The position taken by OCC so far would place Farmer Mac in an inequitable position relative to the treatment already accorded to FNMA by OCC for housing programs FNMA operates that are functionally equivalent to Farmer Mac's. The failure of OCC to apply its current regulations in a manner consistent with its treatment of FNMA will significantly limit the participation of national banks in the Farmer Mac program.

Farmer Mac is currently working with OCC to resolve this issue, and specifically communicated this position to OCC in a September 20, 1989, letter (copy attached as Exhibit L), with the concurrence of both the American Bankers Association and the Independent Bankers Association of America. (See also, OCC letter of August 11, 1989, attached as Exhibit M.) The failure of the OCC to respond affirmatively to the Farmer Mac request would have a chilling impact on Farmer Mac's ability to attract originators and poolers to the program.

We recognize that the rules of a regulatory agency such as OCC are under constant review. Thus, if and when the rules applicable to FNMA are modified it is contemplated that the Farmer Mac program would necessarily have to conform to then existing requirements for FNMA. For current purposes, however, the ability of Farmer Mac to compete efficiently in the capital markets is contingent on receiving a favorable response from OCC to its request.

Lending Limits - The Independent Bankers Association of America has requested an interpretive ruling to the effect that the non-participation portion of a

loan sold to a certified facility for pooling should not weigh against the originating bank's lending limits.

Glass-Steagall Act. Farmer Mac's counsel has prepared a request to the OCC to confirm that Farmer Mac-guaranteed securities are eligible for unlimited purchase, dealing in, underwriting and holding by national banks under 12 U.S.C. § 24.

Department of Treasury - By letter dated February 17, 1989, John Dahl, as Chairman of the Interim Board of Directors of Farmer Mac, requested that the Secretary of the Treasury exercise the discretion granted to the Secretary by Congress and authorize Farmer Mac to use the book-entry system of the Federal Reserve System for Farmer Mac-guaranteed securities. Access to the Federal Reserve's book-entry system would permit Farmer Mac-guaranteed securities to be traded without the need of producing a physical security. A favorable determination by Treasury is extremely important to Farmer Mac for the following reasons. First, it would place Farmer Mac-guaranteed securities on a par with those of other GSEs that are allowed book-entry trading. This should support the quasi-Federal status of Farmer Mac-guaranteed securities that is critical for them to be favorably priced. Second, it would eliminate the unnecessary expense and inefficiency involved with trading of physical securities. Finally, it is consistent with Congressional intent and with agreements between members of Congress and the Secretary of the Treasury during the conference on the Farmer Mac legislation in late 1987. Farmer Mac has communicated regularly with representatives of the Secretary of the Treasury but is still awaiting a decision on this issue. I want to express my appreciation to the Chairmen and Ranking Members of the House and Senate Agricultural Committees for their support of our efforts to get favorable treatment from Treasury on this matter (copies of letters to

Secretary Brady attached as Exhibits N and O), and my concern that even with this support Treasury Secretary Brady's staff has still failed to reach a decision on the matter.

Securities and Exchange Commission - In February and September 1989, representatives of Farmer Mac met with the staff of the Division of Corporate Finance to discuss expedited registration procedures for Farmer Mac-guaranteed securities. The staff has expressed its willingness to work with Farmer Mac to streamline registration procedures. It is the position of the SEC staff, however, that Rule 415 "shelf registration" will not currently be available to Farmer Mac, though it may become so at a later date after the SEC completes a general review of the rule with a view to expanding its availability. Thus, at present, we will only be able to offer poolers expedited SEC registration procedures. Poolers have already indicated to Farmer Mac their misgivings about this arrangement, for they must bear market risk on the securitized mortgages during the review period.

Farm Credit Administration (FCA) - Of serious concern to Farmer Mac at this time is the posture that has been adopted by the Farm Credit Administration (FCA) staff with regard to the adequacy of the standards. In reaching its position, we are concerned that the FCA staff apparently focussed in on the various ratios and other provisions without considering the cumulative effect of the standards and the interaction among them. Moreover, there does not seem to be a good comprehension of the fact that pools of qualified loans will be subjected to considerable further evaluation before the guarantee is provided. Our principal responses to the FCA staff's concerns are:

- The standards were developed to serve as guiding principles for the program within the relatively short period of 120 days

that Congress provided for the task. This was done with the input of a great many experts from the agricultural credit sector. However, the standards are not intended to provide specific details for program operation.

- In order to avoid excluding from the program the majority of agricultural producers in the country, it was necessary to design the standards as a first screen for the process. That is, the standards create a reasonable credit risk profile for agricultural borrowers, with sufficient flexibility provided for to include all segments of agriculture.

- We recognize that experience may dictate refinements to the Securities Guide, which allows for maximum flexibility in making such changes.

- The agency does not give due credit to the fact that the standards will actually be applied on a pool by pool basis rather than on a loan by loan basis. Finally, it is not necessary for the standards to establish a zero loss tolerance for loans accepted into the pools because the statute specifically requires a 10 percent cushion for losses before the guarantee provisions can be invoked.

The standards submitted to the Subcommittee have been specifically designed to achieve the intent of Congress to provide farmers and ranchers access to new sources of

funds through national capital markets. We agree that any one of the standards could probably be made more strict; however, this is not necessary to achieve a reasonable level of confidence that the program can be operated in a safe and sound manner, and would substantially defeat the objective of the program.

CONCLUSION

Farmer Mac has accomplished much in the year since the Interim Board first met. There are a number of significant issues which I have mentioned today that will need to be resolved to make the secondary market for agricultural real estate and rural housing loans as effective and efficient as possible.

Farmer Mac's Board of Directors and its management are pledged to make the secondary market for agricultural real estate loans and rural housing loans successful. We appreciate your interest and thank you for the opportunity you have provided us to make this statement.

(Attachments follow:)

SCHEDULE I

RURAL HOUSING

Principal Amount - The value of a dwelling to be financed by a rural housing loan may not exceed $100,000 (as adjusted for inflation) according to the provisions of the Act.

Loan-to-Value Ratio - For rural housing loans, the 75% loan-to-market value ratio may be reached in part with private mortgage insurance support ("PMI"). This means that 100% of the value of the dwelling may be financed if 25% of the loan is covered by PMI.

Loan Term and Repayment - Loans should be fully amortizing over a period not to exceed 30 years.

Property Exceptions - Farmer Mac underwriting standards for rural housing are based on common industry norms for residential mortgages eligible to be sold in the secondary market similar to those of the Federal National Mortgage Association, adjusted to reflect the usual and customary characteristics of rural housing. Due to the nature of rural housing Farmer Mac will accept the following property irregularities normally associated with rural housing. These regularities should be offset by other compensating factors as described below.

Property exceptions to be normally permissible for Farmer Mac rural housing loans:

(1) properties that utilize wells, cisterns, shared and private disposal systems;

(2) properties dependent on community water systems that are not approved by the local government, covered by a maintenance agreement or provide the right to access to the system;

(3) properties that have unusual or non-standard easements;

(4) properties with larger sites than those for normal residential properties in the area;

(5) properties located in areas less than 25 percent developed and/or the value of the site exceeds 30 percent of the appraised value;

(6) properties which possess significant out buildings, provided little or no value is assigned to the buildings;

(7) properties that mix rural residence and business use;

(8) properties with minimum square footage which would not be marketable in the area, provided the borrower intends to remain on the property for the term of the loan; and

(9) properties that are located on community owned or private roads that do not have specific maintenance agreements provided the current roads are accessible.

Additional Considerations - When underwriting property exceptions, it is the primary responsibility of the Originator and Pooler to ensure that the interests of Farmer Mac are protected. Therefore, property exceptions should be compensated for with other factors such as strong income or credit history which would enhance the performance of the loan. Other considerations are as follows:

Employment Stability. Borrowers should establish long-term employment and stable income. Long-term employment is defined as at least two years of successful experience.

Income. Balance sheets and income statements for three years should be obtained where possible to verify reported income. Primary income should be stable over the last two to three years. Other income that can be taken into consideration in qualifying the borrower includes:

- Interest and divided income, if properly documented and has consistently been received over the last two years.
- VA benefits, if they are documented by a letter or distribution form from the VA.
- Rental income, provided it has been collected consistently over the last two years.

Income Verification. Acceptable forms of income verification include:

- Balance Sheets and Income Statements
- Federal Tax Returns
- Bank Statements and Income Verifications
- W-2 Forms

Credit Verification. Past credit history should be verified through a recent credit report.

Income Ratios. The following income ratios should be calculated in accordance with the Farmer Mac Credit Underwriting standards.

- Monthly Housing Expense to Income
- Total Obligations to Income

SCHEDULE II

FARMER MAC - STOCK OWNERSHIP SCHEDULE

Non-Farm Credit Institution Size	Dollar Amount of Consolidated Assets	Class A Voting Common Stock Ownership Requirements
Small	Up to $50 million	100 shares
Intermediate	$50 to 100 million	200 shares
Large	$100 to 500 million	500 shares
Major	Over $500 million	2,000 shares

Farm Credit Institutions	Class B Voting Common Stock Ownership Requirements
All sizes	100 shares

(The following exhibits are held in the committee files:)

EXHIBIT TABLE OF CONTENTS

A - OFFERING CIRCULAR

B - PROXY STATEMENT

C - ELIGIBILITY STANDARDS FOR CERTIFIED FACILITIES

D - CREDIT UNDERWRITING, LOAN REPAYMENT AND SECURITY APPRAISAL STANDARDS

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STATEMENT OF

THE AMERICAN BANKERS ASSOCIATION

ON

THE FEDERAL AGRICULTURAL MORTGAGE CORPORATION

BEFORE THE

HOUSE AGRICULTURE SUBCOMMITTEE

ON

CONSERVATION, CREDIT, AND RURAL DEVELOPMENT

BY

MICHAEL GROVE

ON

SEPTEMBER 27, 1989

29-522 0 - 90 - 4

Mr. Chairman and Members of the Board, my name is Mike Grove, President, First National Bank, White Sulphur Spring, Montana and a member of the American Bankers Association's Agricultural Bankers Division Executive Committee. My institution purchased enough Federal Agriculture Mortgage Corporation (Farmer Mac) Class A stock to be eligible to participate in the program as an originator. I am here today representing the American Bankers Association.

The combined assets of ABA members comprise approximately 95 percent of the total assets of the commercial banking industry, including 5,000 agricultural banks. While our members range in size from the smallest to the very largest banks, some 85% have assets of less than $100 million. One of the advantages that the American Bankers Association has in its discussion of Farmer Mac is that we have access to the resources of small community and agricultural banks, regional banks, and money center banks which have an interest in restoring economic vitality to the rural communities of this country through a secondary market for agricultural real estate and housing loans.

ABA has recognized the need for the development of a secondary market for agricultural loans, particularly agricultural real estate loans, since the late 1970's and the early 1980's. In 1987, in cooperation with the American

Council of Life Insurance (ACLI), the Independent Bankers Association of America (IBAA), and major farm groups, ABA worked with the Congress to authorize a secondary market for agricultural real estate and rural housing.

The ABA has continued to play an active role in the development of the market, working with the Farmer Mac Interim Board of Directors, the permanent board, and various developmental task forces. ABA was also instrumental in the sale of common stock involved in the initial capitalization of Farmer Mac. We are proud of the role that we have played in the past in bringing Farmer Mac to this stage of development, and we look forward to working with the Congress, the board, and the agricultural and housing industries as Farmer Mac moves forward to help address the credit needs of rural America.

This secondary market for agricultural real estate was created for some very specific purposes. It was designed to provide competitive sources of financing for agricultural real estate to the farmers and ranchers of this country. It was designed to provide a source of long term, fixed interest rate financing to these farmers and ranchers at a reasonable cost. It was also designed to provide a financing mechanism that reduced some of the volatility in the provision of credit to agriculture. It is important to reiterate these goals for this secondary market before

focusing on a few of the specific details of Farmer Mac's structure lest we all lose sight of the reasons for its creation. These are important goals. Farmer Mac must be viable to achieve them.

Having noted the goals of Farmer Mac, let me state at the outset that ABA has always believed that the underwriting standards should be designed to ensure the safe and sound operation of the secondary market. They must provide confidence to farm borrowers, lenders, investors, other participants in the secondary market, and the American taxpayers who ultimately stand behind the securitization process of the secondary market. At the same time, we feel that the underwriting and appraisal standards of Farmer Mac must be flexible enough to ensure the broadest possible availability of credit without damaging the market's safety and soundness. To err toward either extreme would, in our view, lessen the considerable potential of the secondary market to revolutionize agricultural lending in years ahead. It would deprive many deserving farm borrowers and rural home owners of the many benefits that Farmer Mac has to offer. Thus, after careful analysis of the draft standards, we offered a series of concerns and proposals for modification which we wanted to see incorporated into the underwriting standards.

It is apparent to us that the Farmer Mac board took note of our proposals (and the proposals of others) in amending the Discussion Draft standards. To illustrate, we have prepared and attached a document that compares the original draft standards, ABA's comments from our May 5th testimony presented to the Farmer Mac board, and the amended standards that were sent to the Congress on June 30, 1989.

We believe these standards are reasonable and workable. When the ABA's Agricultural Bankers Division Executive Committee met in July, they released a statement commending the Farmer Mac board for its expeditious action to develop the framework for the provision of credit in this secondary market. The time frame was and is short; the achievements on the part of Farmer Mac so far are commendable. Significant problems for the development of Farmer Mac remain, but the efforts of those involved so far must be applauded.

Therefore, our testimony today is based on a belief that the standards as written provide the flexibility needed for financing the purchase of farm real estate and rural houses. This flexibility is best illustrated by inclusion of Credit Underwriting Standard #9 which states:

Farmer Mac may, on a pool-by-pool basis, accept loans that do not conform to one or more of the preceding standards when:

(a) those loans demonstrate compensating strength on one or more of the standards to which they do conform; and

(b) those loans are made to producers of particular agricultural commodities or products in a segment of agriculture in which such non-conformance and compensating strength are typical of the financial condition of sound borrowers.

Furthermore, when concern arose recently over the interpretation of the term "Net Property Income Valuation", the Farmer Mac board was able to allay these concerns because of the way the credit underwriting standards and appraisal standards work together to allow flexibility. In the end, the Farmer Mac board was able to issue clarifying notes that indicated how "Net Property Income Valuation" would be determined when an existing farm owner/operator used Farmer Mac financing to purchase additional farmland. This clarifying note confirmed ABA's original interpretation of the appraisal and underwriting standards.

As a final comment on the Credit Underwriting Standards, the ABA must stress again that profitability is a key element affecting whether a farm can operate and survive long term. Therefore, when a farming operation demonstrates a history of profitability but does not conform to all of the ratios outlined in the Credit Underwriting Standards, Farmer Mac should use its discretion to accept the loan under Credit Standard #9. If Farmer Mac ignores profitability, and focuses too heavily on ratios (such as the debt-to-asset ratio), it may lead to asset-based lending.

In examining the "Eligibility Standards for Certified Facilities", it is difficult to comment on many of the proposed criteria for certified facilities issued by Farmer Mac because there are frequent references to the as yet-unpublished "securities guide". Obviously, until the securities guide is available, we are unable to give its contents careful analysis. As an example, the reference to compliance by loan originators and servicers with environmental management procedures contained in the "securities guide" is the type of specific procedures that the ABA must comment upon when the guide is available.

Furthermore, the criteria direct certified facilities to "identify capable originators" and "enter into

agreements" with originators on a variety of matters relating to originating and servicing of loans. This requirement causes ABA to have some concern for small originators who may deal with only a few loans each year. Our concerns on this point are as follows:

- Certified facilities may establish their geographic network of originators and may be reluctant to establish working agreements with institutions that process only a few loans each year.

- Certified facilities may find it uneconomical to purchase small loans because the acquisition costs may exceed the value that these loans would add to a pool.

- Certified facilities may consider it too risky to rely on the representations and warranties of small originators, especially if the institutions originate only a few loans each year. Therefore, they may avoid dealing with such institutions.

We believe that for Farmer Mac to fulfill its promise to the agricultural community, it must ensure that there is ready access to Farmer Mac programs by all stockholders. Participation by many loan originators is the best way for the benefits of Farmer Mac to be delivered to farmers and ranchers, large and small, throughout the nation. ABA

believes strongly that there must be competition between both originators and poolers. Therefore, we look forward to the publication of the "securities guide" which we hope will further clarify our understanding of the more general underwriting and certification standards and ensure that the interests of small institution originators' and individuals with small farms will be protected.

However, we still do have very real concerns because there are issues which, if not corrected by the regulators, may have to be addressed in the legislative arena for Farmer Mac to become operable. We plan to continue working with Farmer Mac and the banking regulators to develop means for the regulators to treat loans sold into this secondary market as assets sold and removable from the books of bank originators. Similarly, there remain significant questions as to the regulatory treatment of securities created by bank poolers under the program. ABA will continue to be involved in this issue as well.

These last concerns are part of a major, complicated issue. We look forward to working with the Farmer Mac board, bank regulators, and the Congress to resolve this major obstacle to Farmer Mac's fulfillment of its promise. This new financing mechanism is a necessary part of rural development. ABA is convinced that any obstacles to its

implementation should be overcome to ensure the economic viability of agriculture and small towns in this country.

(Attachment follows:)

THE ABA'S STANDARD-BY-STANDARD COMMENTARY ON
THE ORIGINAL CREDIT UNDERWRITING STANDARDS
AND THE AMENDMENTS TO THOSE STANDARDS
PRESENTED TO CONGRESS FOR REVIEW

ABA's testimony on the April 12, 1989 discussion draft:

FAMC Credit Underwriting Standard 1 states that "A complete and current credit report, in a form acceptable to the FAMC will be obtained. The report must include a current UCC lien search, historical credit experience, a reporting of all debts, and all pertinent legal information."

The ABA agrees with Farmer Mac in stating that current information regarding UCC liens, knowledge of the applicant's credit history, and a listing of all debts are necessary in making a determination as to an applicant's eligibility for credit. However, this information is currently collected by bankers from a variety of sources, using a variety of forms. The facts will show that very few commercial farming operations carry a "Dun & Bradstreet" commercial listing or a TRW consumer credit rating.

Therefore, we feel that Farmer Mac might add a greater degree of flexibility to this standard by substituting the words "credit application" for "credit report". Adoption of a standardized credit application for the Farmer Mac program will closely parallel the standard application practice that now exists for residential housing loans sold into the secondary market, as well as the standard application practice that exists for Small Business or Farmers Home Administration Guaranteed Loan Programs. It is even conceivable that the information that Farmer Mac deems the most necessary for successfully processing a loan application can be reduced to a series of questions with answers certified by the borrower and the loan originator. Furthermore, as experience and time dictate, the series of questions can be changed to provide only the most currently required information.

Amendments to the April 12, 1989 discussion draft:

1. A complete and current credit report, in a form acceptable to the Federal Agricultural Mortgage Corporation ("FAMC" or "Farmer Mac") will be obtained. The report must include a current Uniform Commercial Code lien search, historical

credit experience, reporting of all debts, and all pertinent legal information.

ABA's testimony on the April 12, 1989 discussion draft:

FAMC Credit Underwriting Standard 2 states that "The borrower will provide at least the current year's fair market value balance sheet and three years of income statements (current & two preceding years) to be analyzed, with adjustments made to at least the current financial statement to reflect the value of production (by recognizing noncash expenses and changes in inventory, accounts payable, accounts receivable and prepaid expenditures)."

The ABA applauds the efforts of the Farmer Mac Credit Underwriting Task Force in recognizing the special needs of beginning farmers or "newer" farm operations. However, it may be more appropriate to address these needs as "exceptions" to the Standards, rather than have these needs set the Standards. Indeed, the notes that accompany this standard indicate that "the one-year rule should be applied only when sound credit judgement permits". The ABA would agree that this will allow for greater flexibility in analyzing farm credits. However, we feel that the Standard itself should make the same three year requirement on balance sheet information that it requires on income statement information. Thus, we think it appropriate for Farmer Mac to require the same number of years of balance sheets as it requires income statements (as opposed to the one year balance sheet, three year income statement requirement that the Standard now sets). Most bankers and farm financial analysts feel it is imperative to have both balance sheet and income statement information available on an annual basis in order to effectively analyze the trends of an individual farm operation.

We would recommend that Farmer Mac Credit Standard 2 be strengthened to require three years of fair market value balance sheets and income statements, with the notation that exceptions to this Standard will be permitted for entities that have been in operation for less than three years, and/or only when sound credit judgement permits. These newer entities should then be required to comply with the minimum one-year fair market value balance sheet Standard.

In addition, the ABA is concerned that Credit Underwriting Standard 2, as presently written, may be somewhat confusing in its usage of terminology. In this Standard, there is reference to "the current financial statement" containing the "value of farm production". This stipulation might appear contradictory in light of current farm financial practices. There are two reasons for this.

First of all, most bankers presently interpret the term "financial statement" to mean the farm balance sheet. Secondly, there is not usually an adjustment to the balance sheet for the value of farm production. Instead, the value of farm production is commonly handled as an adjustment to the income statement.

It is also important to note that the calculation method cited by Farmer Mac for calculating the value of farm production(VFP) is, in fact, the method most farm financial analysts use to arrive at an accrual adjusted income statement, or use to make "accrual adjustments" to a balance sheet. Farmer Mac might want to compare their calculation to one of the more common methods for calculating VFP. One method of calculating VFP is to take total cash sales value of products and services, less the total value of purchased feed and livestock, plus changes in the value of crop and livestock inventories, plus the value of farm products used on the farm. A second method for calculating VFP is the same as above , but also includes changes in accounts receivable. Therefore, it may be important that Farmer Mac look at some nationally recognized calculation methodology in order to be able to accurately compare data submitted by each of the loan originators. The ABA would recommend that Farmer Mac examine the reports of the Farm Financial Standards Task Force for some guidance in this area.

Beyond these, the ABA is concerned that there is no indication as to how the FAMC will treat off-farm assets or income derived from these assets. Will these items be included or excluded from the balance sheet and income statement? There is no direction given as to what information is to be included in the balance sheet (i.e. does one include contingent liabilities, future Conservation Reserve Program payments, leasehold interests, deferred taxes, Commodity Credit Corporation (CCC) grain and loans against it, etc.?). Furthermore, there is no indication as to how to properly prepare the income statement (i.e. how does one account for off-farm income, income from the sale of capital items, extraordinary income or expenses, etc.?).

The ABA does not mean to imply that the Farmer Mac Credit Underwriting Standards should address all of the above issues. However, we would again encourage the Farmer Mac Board to consider the work of the Farm Financial Standards Task Force and other nationally recognized farm credit analysts in any standards or regulations that may be needed to address these issues.

Amendments to the April 12, 1989 discussion draft:

2. The borrower will provide fair market value balance sheets of even date and income statements for at least the current year and the two immediately preceding years with adjustments made to at least the current financial statement

to reflect the value of production (by recognizing noncash expenses and changes in inventory, accounts payable, accounts receivable and prepaid expenditures).

Notes on Credit Standard 2 Amendments:

Detailed consideration was given to the need for borrowers to provide balance sheets for three years. This might be a difficult standard to meet all of the time. For example, new borrowers would not have balance sheets for three years. Therefore, although a minimum requirement of three years' financials was set, it is not intended to exclude loans for which as few as one year's financials are available, with the understanding that specific procedures permits. Having just the current year balance sheet makes any computation of adjusted income difficult. Also, the inability to develop balance sheet trends may be a disadvantage to the lender. Justification for this variance will be discussed in Farmer Mac's written procedures.

ABA's testimony on the April 12, 1989 discussion draft:

FAMC Credit Underwriting Standard 3 states that "The entity being financed should have a pro forma (after closing any new loan) debt-to-asset ratio of 50% or less. Exceptions to this standard will be permitted for entities that present a strong history of earnings or liquidity."

The ABA feels that a 50% debt-to-asset ratio is a conservative cutoff point, and sets a standard that will ensure that loans are made to financially healthy farm operations. However, we would caution Farmer Mac not to place too much emphasis strictly on the debt-to-asset ratio as that practice may lead to asset-based lending activities. We are pleased to see that Farmer Mac has also allowed for exceptions to this standard, and that there is recognition on the part of Farmer Mac (in Standards 4 & 5) that liquidity and debt coverage ratios are important indicators of farm financial health.

At this time, the ABA would like to draw the attention of the Farmer Mac Board to one area of farm financial analysis that appears to be somewhat ignored in setting up Credit Standard 3, 4 & 5 - the area of farm profitability. Most bankers recognize that there are five categories of farm financial ratios - profitability, solvency, liquidity, debt coverage, and efficiency. The lessons of the farm financial crisis have taught bankers not to place too much emphasis on a few ratios to the exclusion of the other ratios. Thus, we are concerned that the Farmer Mac Credit Underwriting Standards, as proposed, make no attempt to directly assess the level of profitability of a prospective borrower's farming operation. Therefore, we would

strongly recommend that Farmer Mac examine profitability ratios (such as return on assets, return on equity, and return on assets divided by return on equity)in order to assess whether an operation is effectively leveraged. We feel this profitability assessment is more important than the examination of solvency, liquidity and debt coverage ratios in determining the long term survival of a farm operation.

The ABA would also like to caution that the debt-to-asset ratio may be grossly distorted by the presence of large inventories of sealed CCC grain - grain that is "the same as sold" but still not disclosed that way on the balance sheet. For an example of how a debt/asset ratio can be distorted by CCC sealed grain vs. sold grain, take a farm with $100,000 in CCC grain and $800,000 of total assets with $100,000 of CCC loans and $450,000 total debt. This farm will not have a 50% debt/asset ratio. However, if the grain were sold instead of sealed, the total assets would be $700,000 and total debts would be $350,000 - hence, the farm would have a 50% debt/asset ratio.

Amendments to the April 12, 1989 discussion draft:

3. The entity being financed should have a pro forma (after closing any new loan) debt-to-asset ratio of 50% or less.

Notes on Credit Standard 3 Amendments:

For purposes of this Standard 3 and Standard 5, "pro forma" connotes a restatement of the financial data of the entity being financed, to include in that entity's current and historical financial statements the assets collateralizing the proposed loan, income derived from those assets, the proposed loan, and debt service thereon.

ABA's testimony on the April 12, 1989 discussion draft:

FAMC Credit Underwriting Standard 4 states that "The entity being financed shall generate sufficient earnings and liquidity to meet all capital obligations as they come due over the term of the loan and, in addition, provide a reasonable margin for capital replacement and contingencies. This standard is achieved by having : (a) total debt coverage in a financing of no less than 1.25:1; (b) A current ratio of no less than 1:1. Both of these ratios will be computed on a pro forma basis (after closing any new loan). Elements of the debt coverage ratio shall include historical and projected earnings. "

As we stated earlier, the Farmer Mac Credit Underwriting Task Force should be praised for recognizing that they must also consider debt coverage and liquidity ratios in analyzing a farm operation. However, we are concerned that this proposed standard

attempts to establish minimum parameters for all types of farming operations, while not allowing for any exceptions to these parameters. As further explanation of our concerns in this area, we would like to draw the attention of the Farmer Mac Board to the types of data compiled by Robert Morris Associates (RMA) in their comparative analysis of 89,000 commercial businesses. Out of these 89,000 submissions, RMA recognizes and sets different parameters for 355 different types of businesses. In light of the over 600,000 commercial farming operations with annual sales in excess of $40,000, we feel it would be difficult for one set of parameters to be applicable to all types of operations.

It is noted in their comments that the Farmer Mac Credit Underwriting Standards Task Force attempted to allow for capital replacements by setting a 1.25:1 debt coverage ratio. However, the ABA would like to suggest that a more accurate method to approach this dilemma would be to include an estimate of capital replacement costs as one of the items subtracted from net income in the numerator calculation of the debt coverage ratio. This would allow Farmer Mac to get by with a somewhat lower parameter for the debt coverage ratio, and thus, prevent the unfair exclusion of many financially healthy operations. This alternative calculation method may even prevent Farmer Mac from falsely assuming that operations whose asset loans are being repaid more slowly than they are being depreciated are more profitable than operations whose asset loans are being repaid more quickly than they are being depreciated.

In addition, the ABA would advise Farmer Mac to recognize that different current ratio standards should exist for different types of farm firms or similar types of farm firms in different geographic locations. Thus, enforcement of a 1:1 current ratio on a dairy operation may be a more stringent requirement than the 1:1 current ratio being enforced on a cash grain operation.

Therefore, the ABA would encourage Farmer Mac to work more flexibility into the parameters being set for debt coverage ratios and current ratios. This flexibility may be established through the lowering of standards, the restructuring of calculations, or by including a phrase that states that "exceptions to this standard will be permitted for entities that present a strong history of earnings or liquidity".

Amendments to the April 12, 1989 discussion draft:

4. The entity being financed shall generate sufficient earnings and liquidity to meet all capital obligations as they come due over the term of the loan and, in addition, provide a reasonable margin for capital replacement and contingencies. This standard is achieved by having:

   (a) A total debt coverage ratio in a financing of no less

than 1.25:1, including net income from farm and non-farm sources; and

(b) A current ratio of no less than 1:1.

Both of these ratios will be computed on a pro forma basis (after closing any new loan). Elements of the debt coverage ratio shall include historical and project earnings.

Notes on Credit Standard 4 Amendments:

Specific ratios were discussed and presented in Standard 4.

(a) Total Debt Coverage Ratio

Net Farm Income	
+ Depreciation	
+ Interest on Capital Debt	
+ Capital Lease Payments	
+ Net Off-Farm Income	
+ Capital Lease Payments	Principal and Interest
- Living Expenses	on Capital Debt
- Income Taxes	+ Capital Lease Payments
= Numerator	= Denominator

(b) Current Ratio

Current Assets/Current Liabilities

Current assets should be valued at the lower of cost or market until such time as market value can be readily established. Current liabilities should include all principal due within one year and accrued interest as of the date of the balance sheet.

ABA's testimony on the April 12, 1989 discussion draft:

FAMC Credit Underwriting Standard 5 states that "The loan-to-appraisal value ratio in a financing shall not exceed 75%. Also, a minimum 1:1 cash flow debt service coverage ratio from the subject real estate will be required. The analysis of this ratio shall be computed on an owner-operated basis."

While the 75% loan-to-value ratio is different from the congressionally set limit of an 80% loan-to-value ratio, the ABA recognizes that this is may not be an unreasonable requirement for the initial stages of the secondary market. However, the ABA would like to see Farmer Mac acknowledge that a mortgage insurance mechanism, similar to the "PMI" insurance they refer to in Standard 8, may be permitted in farm real estate transactions in order to maximize the use of the Farmer Mac program by farm borrowers. This type of mortgage insurance does not presently

exist. However, if the Farmer Mac Board will set standards that allow for agricultural mortgage insurance to satisfy a portion of the requirements cited in this standard, it is conceivable that ag mortgage insurance might be developed by the private sector.

In addition to these suggestions, the ABA would like to point out that the "1:1 cash flow coverage ratio" requirement will preclude from Farmer Mac those farmers who want to use off-farm income or other farm income to make their farm payments. In light of this, some modification of the 1:1 ratio would be appropriate. An example of why exceptions to this parameter should be allowed are best determined by the following: assume that a farrow-to-finish hog operation that would like to purchase an 80 acre tract of good crop ground for growing corn. In reality, in the majority of years, if the corn crop were sold off this farm it might not satisfy the total debt requirements. However, if the corn is fed through the hogs on the "other" part of the operation, it might increase overall profitability enough to justify the real estate purchase. Indeed, in this example it would be difficult to analyze the "subject" real estate on a stand alone basis.

Amendments to the April 12, 1989 discussion draft:

5. The loan-to-appraisal value ratio in a financing shall not exceed 75%. A minimum 1:1 cash flow debt service coverage ratio from the subject real estate will also be required, except with respect to loans in which:

   (a) the borrower's principal residence is on the property securing the loan; and

   (b) the pro forma debt coverage ratio of the entity being financed has for the last three years been no less than 1.5:1.

   The analysis of the 1:1 cash flow debt service ratio shall be computed using the Net Property Income determined by the appraiser.

ABA's testimony on the April 12, 1989 discussion draft:

FAMC Credit Underwriting Standard 6 states that "The property financed shall meet the minimum acreage or minimum annual receipts requirements established by FAMC."

Obviously there is not enough detail in this standard to make comments. Therefore, we can only remind Farmer Mac that there is a wide variety of farm operations, and that to be fair to the stockholders who have invested in Farmer Mac and their farmer borrowers, FAMC should not set future minimums that are too restrictive.

Amendments to the April 12, 1989 discussion draft:

6. The property financed shall meet the minimum acreage or minimum annual receipts requirements established by FAMC.

ABA's testimony on the April 12, 1989 discussion draft:

FAMC Credit Underwriting Standard 7 states that "Loan conditions such as loan agreements, personal liability, additional collateral, title and casualty insurance, etc., shall be required. The loan must be a level-pay, fully amortized loan. The term of the loan shall not exceed 30 years. "

Without additional information, the ABA cannot fully comment on this requirement. However, the ABA would like to point out that Farmer Mac will hold a very secure lien position in the Farm Real estate, and therefore should find it unnecessary to require additional collateral. Furthermore, if Farmer Mac does place liens on collateral other than the real estate securing the loan, it may very well hamper the ability of the farm operator to obtain funds for farm operating expenses.

Furthermore, the ABA would also suggest that Farmer Mac determine the impact of this standard on farms that are located in states that do not have title insurance, or in states that do not enforce personal liability on farm debt.

Amendments to the April 12, 1989 discussion draft:

7. Loan conditions such as loan agreements, personal liability, additional collateral, title and casualty insurance, etc., will be required. The loan must be level-payment or level-principal payment, and either:

   (a) fully amortize principal over a term not to exceed 30 years; or

   (b) amortize principal according to a schedule not to exceed 30 years, and mature no earlier than the time at which the remaining principal balance of the loan equals 50% of original appraised value of the property securing the loan.

Notes on Credit Standard 7 Amendments:

This standard seeks to include most loan structures in which principal is fully amortized over the life of the loan. Adjustable rate mortgages that conform to this requirement may be included in pools. In addition, so-called "balloon payment"

loans may be included.

Where buildings comprise a material portion of the value of the real property, the schedule for the amortization of principal should not extend beyond the useful life of those buildings.

Farmer Mac has determined not to take a position on the use of disincentives to loan prepayment, such as "points up-front," sliding scale prepayment penalties, or "yield maintenance" prepayment provisions. Recognizing that the use of these disincentives is a market-driven matter and, in fact, perhaps illegal in some states, Farmer Mac has chosen to leave this matter to originators and certified facilities to work out with their customers.

ABA's testimony on the April 12, 1989 discussion draft:

FAMC Credit Underwriting Standard 8 states that "For rural housing loans, FAMC should adopt credit underwriting standards similar to those of FNMA. The 75% loan-to-market value ratio may be reached in part with insurance support, and the FNMA standards should be adjusted to reflect the usual and customary characteristics of rural housing."

It is apparent from this standard that Farmer Mac has looked at the success of FNMA and sought to emulate it. However, the ABA would like to caution Farmer Mac in this emulation. We feel that the need for the inclusion of rural residential housing provisions of the Farmer Mac legislation was due to the inability of FNMA to successfully utilize their program to provide credit in these areas. Thus, to closely parallel FNMA would not resolve this problem.

Furthermore, it is difficult for the ABA to understand why Farmer Mac would insist that PMI be needed once loan-to-value ratios have exceeded 75%. Presently, FNMA and Freddie Mac do not require private mortgage insurance until loan-to-value ratios exceed 80%. The ABA would like to comment further on this standard once more detail is made available by Farmer Mac.

Amendments to the April 12, 1989 discussion draft:

8. For rural housing loans, FAMC will adopt credit underwriting standards similar to those of the Federal National Mortgage Corporation ("FNMA"), adjusted to reflect the usual and customary characteristics of rural housing. For rural housing loans, the 75% loan-to-market value ratio may be reached in part with insurance support ("PMI").

ABA's testimony on the April 12, 1989 discussion draft:

FAMC Credit Underwriting Standard 9 states that "Farmer Mac invites comment on whether income from sources other than the entity being financed, i.e. off-farm income, should be given consideration in the credit underwriting standards."

The ABA feels that in order to maximize the usage of Farmer Mac, off-farm income should be given consideration just like income from other farming operations owned by the prospective Farmer Mac borrower. After all, off-farm employment is merely one method of utilizing the farmer's excess "human resources", whereas a larger sized farming operation may be another method of using these excess resources.

Amendments to the April 12, 1989 discussion draft:

9. Farmer Mac may, on a pool-by-pool basis, accept loans that do not conform to one or more of the preceding standards when:

   (a) those loans demonstrate compensating strength on one or more of the standards to which they do conform; and

   (b) those loans are made to producers of particular agricultural commodities or products in a segment of agriculture in which such non-conformance and compensating strength are typical of the financial condition of sound borrowers.

Notes on Credit Standard 9 Amendments:

Farmer Mac recognizes that the notion of a "sound" borrower will vary, in limited ways, among producers of different agricultural commodities and products. Accordingly, this standard permits the inclusion, on a limited basis, of sound loans that do not conform in every respect to each of the preceding eight standards. Agricultural examples of this kind of exception might typically be found in livestock and poultry feeding operations and/or fruit orchards, where because of their capital intensive operation, the organization becomes leveraged on a current basis. Thus, a borrower might have a debt to asset ratio somewhat higher than 50% and his loan could nevertheless qualify for inclusion in a Farmer Mac pool because total debt coverage in the financing is above 1.25:1 and such ratios are typical of the financial condition of sound borrowers producing the same agricultural commodity or product.

Statement of

Jack W. Dickey

Chairman, Agriculture-Rural America Committee

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

and

President, First National Bank of Thomas

Thomas, Oklahoma

Hearings on

Federal Agricultural Mortgage Corporation

(Farmer Mac)

House Committee on Agriculture

Subcommittee on Conservation, Credit and Rural Development

Hon. Glenn English, Chairman

September 27, 1989

Mr. Chairman, Members of the Subcommittee, I am Jack Dickey, President of the First National Bank, Thomas, Oklahoma. I also serve as chairman of the Agriculture-Rural America Committee of the Independent Bankers Association of America, and I am testifying in that capacity today.

The IBAA is strongly committed to the success of the Farmer Mac program, and we appreciate the opportunity to testify at these hearings on Farmer Mac. It is very constructive and timely for Congress to review Farmer Mac's operations at this time, since the Farmer Mac program is nearing final implementation.

Two recent developments involving Farmer Mac are particularly noteworthy. On September 1, the Federal Agricultural Mortgage Corporation (Farmer Mac) issued an important position statement which can assure that Farmer Mac works successfully through community banks and other local originators of loans to provide the new source of long-term real estate credit to farmers and ranchers that Congress intended in the Farmer Mac statute. This statement is attached, with IBAA's response, as Attachment A. On September 20, Farmer Mac submitted a request for a ruling to Comptroller of the Currency Robert Clarke, regarding the treatment of Farmer Mac loans for purposes of commercial banks' legal lending limits and capital requirements. This letter from Farmer Mac to Comptroller Clarke is attached as Attachment B. Before discussing each of those developments, I would like to briefly discuss the role that community banks played in capitalizing Farmer Mac.

Role of Independent Banks in Capitalizing Farmer Mac

The IBAA has been deeply involved with the Farmer Mac legislation and its implementation for over three years. When the Farmer Mac bill was developed and enacted during 1986-87, as title VIII of the Agricultural Credit Act of 1987, we were especially concerned that the secondary market must provide effective access for the origination of loans by local agricultural banks, within their communities throughout the farm belt, thus providing access to this new source of funds for real estate purchases by rank-and-file farmers and ranchers. As finally enacted in December, 1987, the statute singled out two sets of financial institutions, "originators" and "certified facilities" (poolers), who were jointly charged with capitalizing Farmer Mac and carrying out the Farmer Mac program under the direction of the Federal Agricultural Mortgage Corporation.

Early in 1988, IBAA requested a ruling from the Comptroller of the Currency--and similar measures from the state authorities in major agricultural states--making it clear that national- and state-chartered commercial banks would be permitted to purchase and hold stock in Farmer Mac. The Comptroller's letter of approval is attached (Attachment C).

Both originators and poolers were required to purchase at least a specified amount of Farmer Mac stock in order to originate or pool loans. The statute provided that at least $20 million of stock must be sold for initial capitalization. When the initial stock offering was made late in 1988, the IBAA worked closely with Farmer Mac and the stock underwriters to assure that community banks were informed

of the offering and provided enough time to consider the purchase of stock. Various organizations representing farm producers stressed the importance of local lenders buying into Farmer Mac in order to provide access for farmers and ranchers who would seek Farmer Mac loans in their localities.

Approximately $22.4 million of Farmer Mac stock was sold in this initial offering. About $13.4 million of this was Class A stock bought by financial institutions other than the Farm Credit System, mostly banks and insurance companies. The purchase of Class A stock was split roughly equally between some 1,600 originators who bought about 51.5 percent of the stock, and approximately 30 firms who bought the rest of the stock as potential poolers. Almost 1,500 of the originators were commercial banks, mostly smaller community banks. Some 1,100 (74 percent) of the stockholder originators had assets of less than $50 million, and almost 1,400 (87 percent) had assets of less than $100 million.

We have attached to this statement a list of the states having at least ten bank stockholders in Farmer Mac, with the number of stockholders in each state (Attachment D). It is now very important that community bank stockholders, having contributed in a major way towards the capitalization of Farmer Mac, are able to participate on a broad basis in Farmer Mac.

Maintaining Fair Dealings Between Poolers and Originators

As indicated earlier, on September 1, Farmer Mac addressed a position statement to the IBAA, which specifies several areas of "affirmative action" that Farmer Mac intends to take in order to assure fair dealings of poolers with originators in the Farmer Mac secondary market (Attachment A). Farmer Mac was responding to concerns that IBAA raised beginning three months ago when the "Eligibility Standards for Certified Facilities" was issued, first with Farmer Mac and its board and then with Congress. As indicated in the attached letter to the Chairman of this Subcommittee (Attachment E), we have been particularly concerned that Farmer Mac must be willing and able to oversee the pooler-originator relationships under Farmer Mac in order to assure fair dealings of poolers with originators.

The September 1 letter from Farmer Mac represents a very positive commitment by Farmer Mac in assuming the active oversight of the Farmer Mac market that is essential for community banks and other smaller originators to participate fully in this market. In that letter, Farmer Mac made the following commitments:

1. That "Farmer Mac will take affirmative action to promote the participation of community banks as originators."

2. That relationships between loan poolers and originators must be "fair and reasonable," based upon a pledge by Farmer Mac to review pooler-originator contracts for consistency with the "fair and reasonable" standard and to investigate

promptly each bona fide complaint of a breach of "fair and reasonable" treatment.

3. That poolers may not bypass community banks or others who are Farmer Mac stockholders for the origination of loans.

4. That Farmer Mac is committed to the principle that community banks may service the loans that they originate and will take remedial action against any pooler who seeks unilaterally to deny an originator the right to service a loan.

In addition, Farmer Mac made constructive changes in the loan underwriting standards, making it somewhat easier for farmers to meet the cash flow requirements for the purchase of add-on farmland where the overall farming operation shows a strong debt repayment capacity.

This statement by Farmer Mac provides a sound basis for moving towards the successful operation of the Farmer Mac market. The affirmative role that Farmer Mac has now defined for itself is critical not only to protect the prerogatives of stockholder originators. It is also critical because working through hundreds of local loan originators will enable Farmer Mac to provide the new source of long-term fixed rate financing to rank-and-file farmers and ranchers that Congress intended in enacting the Farmer Mac statute.

We recognize that these positive steps would not have occurred without the active involvement by the Congress, and we appreciate your scheduling these hearings and being involved.

Bank Lending Limit and Capital Adequacy Issues

For commercial banks' participation in Farmer Mac, there are some important bank regulatory issues, involving banks' legal lending limits and capital requirements, that still have to be worked out.

The lending limit issue is critical for the 1,500 commercial banks, mostly smaller community banks, who bought stock to participate in Farmer Mac as loan originators. Those banks are already heavily involved in portfolio agricultural lending, primarily with loans to farmers and ranchers for financing their current operations and other short-term capital needs. With many of their farm and ranch customers, those banks are already loaned up, or nearly loaned up, to the bank's legal lending limit. Such banks would generally still have the capacity, within their lending limit, to retain a participation up to 10 percent in a farm real estate mortgage that would be originated and sold under Farmer Mac, provided that the portion of the loan which is sold basically moves off the bank's balance sheet and does not apply against its lending limit to the borrower.

The capital adequacy issue is also critical with respect to banks' participation in Farmer Mac. Unless that portion of a Farmer Mac loan which is sold or securitized moves off the bank's balance sheet, and does not have to be capitalized against, the additional cost to a bank for participating in Farmer Mac will often outweigh the potential benefits to be derived from Farmer Mac--and prevent the bank from participating as a pooler or originator.

Both legal lending limits and capital requirements serve the same purpose of enhancing the bank's ability to handle its exposure to financial risk. Although the subordinated portion of Farmer Mac loans and loan pools carries a disproportionate risk relative to the entire loan, the Farmer Mac program includes several elements that reduce the loan risk to participating banks. For example:

1. The so-called "catastrophic" risk (that is, the risk of loss in excess of 10 percent of a loan pool) is assumed by the Federal Agricultural Mortgage Corporation.

2. The stringent Farmer Mac loan underwriting, appraisal and repayment standards are designed to assure that only premium quality loans will qualify for Farmer Mac pools; loss exposure on such loans should be much lower than the exposure to loss on random agricultural loans to which legal lending limits and capital requirements would generally apply.

3. Interest rate risk to the bank is eliminated on the portion of the loan or loan pool that is sold under Farmer Mac.

Those risk-mitigating factors for Farmer Mac loans, and the Congressional intent that commercial banks should be allowed to be competitive participants in the Farmer Mac program, ought to provide a basis on which to resolve the bank lending limit and capital requirement issues.

The IBAA and the American Bankers Association have joined in a request by the Federal Agricultural Mortgage Corporation (Farmer Mac)

to the Comptroller of the Currency, asking for treatment of Farmer Mac loans, with regard to legal lending limits and capital requirements, that is equivalent to the treatment given to loans in the Government-sponsored residential mortgage programs administered by the Federal National Mortgage Association (FNMA) or Federal Home Loan Mortgage Corporation (FHLMC). A copy of this letter is attached, as Appendix B. As the attached letter indicates, under FNMA, in particular, the originating bank assumes the entire risk of loss for borrower default on loans sold under the Mortgage Backed Securities program regular servicing option; the program does not provide for any pro rata sharing of losses by FNMA; and yet current OCC policy treats such transactions as sales that permit banks to remove the mortgages from their balance sheets for regulatory accounting purposes. Since the Farmer Mac farm real estate mortgage program will be essentially the same as the FMNA and FHLMC residential housing mortgage programs, the Farmer Mac letter of September 20 asks for parity of treatment for the Farmer Mac program for both legal lending limits and capital requirements.

Farmer Mac's September 20 letter states that this parity of treatment "should apply equally to capital adequacy and legal lending limits with respect to the Farmer Mac program." It is essential that the portion of a Farmer Mac loan sold by an originating bank under Farmer Mac move off the bank's balance sheet to an equal extent for purposes of determining both the bank's legal lending limit and capital requirement--where the bank retains a subordinated participation of up to 10 percent. Smaller banks that want to be loan originators, in particular, could be categorically prevented from participating in Farmer Mac unless the lending limit issue is

resolved. The lending limit issue cannot be satisfactorily resolved unless the originating bank is able to retain a participation in the loan up to 10 percent. Unless they are able to retain a participation interest in the loans that they originate, most community banks would be denied an opportunity for participation in the Farmer Mac program.

The IBAA stands strongly behind the September 20 recommendation by Farmer Mac for resolving the bank lending limit-capital issue. We want to work with you in Congress towards an early resolution of this issue. Comptroller Bob Clarke's door has been open to the IBAA on the issue, and we believe he is sympathetic towards finding an acceptable solution.

There is work yet to be done. However, we are optimistic that Farmer Mac can begin handling loans before the end of this year, and that the Farmer Mac program can operate successfully as intended by the Congress. The IBAA joins with Farmer Mac in a commitment to work closely together to achieve that goal.

This concludes my prepared statement. I would be pleased to respond to any questions.

(Attachments follow:)

Attachment A

Farmer Mac
Federal Agricultural Mortgage Corporation
Suite 200
1667 K Street, N.W.
Washington, D.C. 20006
(202) 872-7700

September 1, 1989

Mr. O. Jay Tomson
President
Independent Bankers
Association of America
One Thomas Circle, N.W.
Washington, D.C. 20005-5802

Dear Jay:

As you know, we had a very productive meeting of the special Task Force on Farmer Mac Underwriting Standard No. 5 last week. Representatives from the insurance industry, the Farm Credit System, the ABA and the IBAA attended the meeting, which lasted almost all day. John Dean did an outstanding job of representing the IBAA and expressing the concerns felt by your members. As a result of the Task Force meeting, a recommendation was made today to the Board of Directors of Farmer Mac that a new note relating to Standard No. 5 be added to the Notes to the Underwriting Standards. I am pleased to report to you that the Board acted favorably upon the Task Force's recommendation. For your convenience, I have included a copy of the text of that note as it was submitted to the Board.

After the Task Force meeting last week, John also took the opportunity to raise with me what he considered the IBAA's other principal concerns regarding Farmer Mac at this time. I would like to take this opportunity to share with you the outcome of our discussion of those concerns.

1. Promotion of interests of community banks - Farmer Mac will take affirmative action to promote the participation of community banks as originators in its programs. In this regard, we shall conduct educational programs for community banks that are originators and prospective originators, work with the associations at the national and state level to identify and develop opportunities for increasing the marketability of loans made by those banks and for pooling those loans at both the national and state levels.

2. Remedy for unfair or unreasonable certified facility contracting practices - Farmer Mac will, as stated in the Eligibility Standards for Certified Facilities, require that all contracts governing the relationships between certified facilities and originators be filed with our office. While we will not act to approve or disapprove such contracts in the ordinary course, we intend to review those contracts in light of our requirement that "certified facilities shall be fair and reasonable in the relationships they establish with originators." Moreover, Farmer Mac undertakes to investigate promptly each bona fide complaint of a breach of that requirement by any party or proposed party to such contracts, both at the time of contracting and throughout the life of the relationship.

3. Protection of loan origination rights - Certified facilities' subcontracting of loan origination is contemplated and permitted by the Eligibility Standards, but Farmer Mac has always intended that such subcontract origination could be performed only by Farmer Mac originators, i.e., holders of the amount of Farmer Mac required for originators within the specified capital bracket as set forth in the original Offering Circular under which the initial public offering of Farmer Mac stock was conducted last fall. We believe this policy should satisfy the concerns previously expressed by the IBAA regarding certified facilities "end running" Farmer Mac originators.

4. Protection of loan servicing rights - The statute that created Farmer Mac provides that "[t]he originator of any loan in such pool shall be permitted to retain the right to service the loan." Farmer Mac is committed to that principle, and will take remedial action against any pooler who seeks unilaterally to deny originators this right. Having said this, we believe it is necessary to make two further observations. First, Farmer Mac will establish its own standards for the credit worthiness of servicers, as protection against financial failures that could affect remittance of payments and advances. Second, it must be recognized that certified facilities and originators may negotiate between themselves as to the allocation of servicing responsibilities, and precedents in the residential markets may be expected to influence those negotiations.

5. Policy on financing of "hobby" farming - After discussion with a number of farm groups, and in light of testimony received at the Public Forum on our discussion draft underwriting standards, the Task Force on Underwriting Standards decided to include off-farm income in determining a borrower's qualifications. That decision necessarily led to the recognition that, in a few instances, it will be difficult to distinguish between part-time farmers and ranchers and "hobby" farmers and ranchers. On balance, the Task Force recommended and the Board of Directors adopted the language of the Underwriting Standards as submitted to Congress, acknowledging that a few loans to "hobby" farmers may be included in the Farmer Mac pools.

I have reviewed the contents of this letter with the Farmer Mac Board of Directors, and they concur in the positions expressed. We appreciate the very useful dialogue between our two organizations, and are confident that we can work together constructively to realize the benefits intended by Congress through the creation and operation of Farmer Mac. We believe that the cooperation demonstrated by John Dean on behalf of the IBAA in our recent meetings typifies the best of our relationship, and we look forward to its continuance in that vein.

Sincerely yours,

Henry D. Edelman
President

29-522 0 - 90 - 5

Note to Credit Underwriting Standard No. 5

When the analysis of the 1:1 cash flow debt coverage ratio is to be calculated for the purchase of land incremental to an existing agricultural production entity, that calculation by the loan analyst may be made by adjusting the Net Property Income to exclude non-operating costs attributable to capital assets not located on the subject property if:

(1) the capital assets of the existing agricultural production entity have sufficient capacity to service the subject real estate; and

(2) other agricultural production entities in the immediate area of the subject real estate typically possess capital assets with sufficient capacity to service the subject real estate; and

(3) the loan-to-appraisal value ratio in such financings does not exceed 65%.

Attachment A

O. Jay Tomson
President
Philip J. Vallandingham
President-Elect
David Baltwer
Vice President
Edward A. Sheldon
Treasurer
J. R. Nunn
Chairman
Kenneth A. Guenther
Executive Vice President

September 5, 1989

Mr. Henry D. Edelman
President
Federal Agricultural Mortgage Corporation
Suite 200
1667 K Street, N.W.
Washington, D.C. 20006

Dear Mr. Edelman:

Thank you very much for your letter of September 1. It is obvious to me from the points covered in the body of your letter that you have taken very seriously the concerns expressed to you by the IBAA regarding Farmer Mac which needed to be addressed and corrected in order to make it a viable, functional tool and effectively meet the intended goals of Congress.

Our mutual goal has been to work with you to make Farmer Mac an effective instrument through which long-term, fixed-rate mortgage loans can be extended to farm operators at reduced rates of interest while maintaining a close borrower-lender relationship between a community bank and its customer.

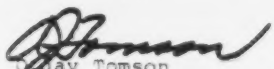
We have worked with you and your board, making suggestions relative to credit underwriting standards. We have strongly expressed the necessity of protecting the rights of loan originators who are shareholders of Farmer Mac stock. We have expressed to you our concern relative to the protection of loan servicing rights. We have stated our apprehension regarding aspects of the appraisal standards that would permit loans to "hobby" farmers. We have expressed our anxieties over possible development of unfair and unreasonable practices emanating from poolers, including their use of "master servicers" which could prove very detrimental to the loan originators and their borrowers. Senator Conrad, Representative English and Senator Grassley were among those who shared our concerns.

You have addressed each of these concerns in your letter and stated further that Farmer Mac will take affirmative action to promote community bank participation as originators in the Farmer Mac program. Affirmative action on both of our parts will be very important if Farmer Mac is to become the success for which we know it has the potential and that Congress fully expects it to become.

There is much work yet to be done. We must work together and perhaps with the Congress in an effort to obtain a favorable ruling from federal bank regulators regarding the treatment of the portion of the loans sold to poolers, both for legal banking purposes and for risk-based capital treatment. Also, we must appear at the Congressional oversight hearings scheduled for later this month and offer testimony regarding the standards and regulations which have been put in place by the Board of Directors of Farmer Mac.

Based on our discussions, those which you have had with various other representatives of the IBAA, and what you state in your letter, I pledge you the support of the IBAA and its member bankers and staff to make the implementation process and the future of Farmer Mac a real success.

Sincerely,



Jay Tomson
President

cc: Jack Dahl, Chairman

Attachment B

Farmer Mac
Federal Agricultural Mortgage Corporation
Suite 200
1667 K Street, N.W.
Washington, D.C. 20006
(202) 872-7700

September 20, 1989

The Honorable Robert L. Clarke
Comptroller of the Currency
490 L'Enfant Plaza East, S.W.
Washington, D.C. 20219

Dear Mr. Clarke:

This is in response to the letter of Donald G. Coonley, Chief National Bank Examiner, dated August 11, 1989, addressed jointly to me and representatives of the American Bankers Association (ABA) and the Independent Bankers Association of America (IBAA). That letter was the direct product of a meeting which took place on August 7, 1989 between representatives of your office and the Federal Agricultural Mortgage Corporation (Farmer Mac), in which I suggested to Mr. Carney that it would be most beneficial to all parties concerned if Farmer Mac, the IBAA and the ABA were to work together toward a single proposal to resolve the issues relating to national bank participation in the Farmer Mac program.

Also at that meeting, Mr. Carney advised us that the most feasible solution to those issues would be to change Farmer Mac's enabling legislation. We do not view that as a realistic solution to the issues we now face. He indicated to us that if we nevertheless desired to pursue an administrative resolution, we would need to find a way to operate within the existing regulatory framework. Recognizing the legal sophistication of that framework, I sought special counsel and retained Richard V. Fitzgerald, Esq.

As a result of consultations with counsel, I have learned that the general rule of the Office of the Comptroller of the Currency (OCC) is that a transfer, or partial transfer, of loans, securities, receivables or other assets from a bank's portfolio constitutes a sale of assets for reporting and capital purposes if the originator bank retains no risk of loss from the assets transferred and has no obligation to any party for the payment of principal or interest on the assets transferred. (See "Sales of Assets," Glossary, Instructions Consolidated Reports of Condition and Income for Insured Commercial Banks with Domestic and Foreign Offices (May 1989), p. A-48.) Thus, the retention of any risk by the bank in the sale of its assets causes that sale to be treated as a financing transaction.

Counsel has, however, advised that current OCC policy provides an exception to the general rule, in the case of banks that dispose of mortgages under certain Government-sponsored mortgage programs providing for loan sales with recourse administered by Federal National Mortgage Association (FNMA) or Federal Home Loan Mortgage Corporation (FHLMC). Under FNMA, in particular, the originating bank assumes the entire risk of loss for borrower default on loans sold under the Mortgage Backed Securities program regular servicing option. This program does not provide for any pro rata sharing of losses by FNMA. (See Fed. Banking L. Rep. ¶27,703 (CCH); (for FHLMC) Fed. Banking L. Rep. ¶27,853 (CCH).) Established OCC policy treats such transactions as sales of assets

for purposes of determining capital adequacy and permits banks to remove mortgages from their balance sheets. (See "Participations in Pools of Residential Mortgages," supra., at A-42.)

The Farmer Mac program will be essentially the same as these Government-sponsored mortgage programs exempted by the OCC from its general rule. The Congressional policy in creating and supporting Farmer Mac, viz., to establish a secondary market for sound credits in agricultural real estate, contemplated regulatory treatment for Farmer Mac equivalent to that accorded to the other Government-sponsored mortgage programs. This treatment should apply equally to capital adequacy and legal lending limits with respect to the Farmer Mac program. Moreover, as a matter of equity, we believe Farmer Mac should be accorded parity with those other Government-sponsored mortgage programs. As you and I have previously discussed, the benefits Farmer Mac will bring to community banks and agricultural banks generally, in the form of reduction of interest-rate risk, improved credit risk, and improved lending and servicing procedures, cannot be overlooked. Such benefits will also inure to the communities in which these banks are located.

The OCC staff has stated its intention to review the current treatment of FNMA and FHLMC programs with a view to changing its policy as to the treatment of loan sales by national banks under those programs. We are certainly prepared to conform with whatever regulations are adopted in that regard but, in the interim, we believe Farmer Mac should be allowed to operate under the same exception to the general rule accorded to the other Government-sponsored mortgage programs.

In consideration of the facts and law set forth in this letter, I would respectfully request your formal concurrence that appropriate equivalent treatment should be accorded to mortgages sold by national banks under the Farmer Mac program as now constituted under the Farm Credit Act of 1971, as amended by the Agricultural Credit Act of 1987, until such time as OCC adopts new regulations relating to such transactions.

This letter reflects the views of the ABA and the IBAA, who join in this request and have authorized me to submit this letter on their behalf as well as that of Farmer Mac.

Very truly yours,

Henry D. Edelman
President

cc: Messrs. D. G. Coonley (OCC)
M. D. Lull (ABA)
C. G. Holthus (ABA)
O. J. Tomson (IBAA)
J. W. Dickey (IBAA)

Attachment

Comptroller of the Currency
Administrator of National Banks

Washington, D C 20219

May 9, 1988

Mr. J.R. Nunn, President
Independent Bankers Association of America
One Thomas Circle, N.W., Suite 950
Washington, D.C. 20005-5802

Dear Mr. Nunn:

I am writing in response to your letter to Comptroller Clarke, dated March 24, 1988, which requests a ruling on the authority of national banks to purchase stock in the Federal Agricultural Mortgage Corporation ("Farmer Mac"). Farmer Mac is intended to facilitate the secondary market in agricultural loans by guaranteeing the principal and interest of securities representing interests in pools of qualified loans, and by developing uniform underwriting standards. The Agricultural Credit Act of 1987 ("Agricultural Act"), which established Farmer Mac, does not specifically authorize national banks to purchase such stock. However, we conclude that the National Bank Act, supported by the legislative history of the Agricultural Act, permits national banks to purchase Farmer Mac stock, subject to certain limitations discussed below.

Under 12 U.S.C. § 24(7), national banks are authorized "[t]o exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; . . . by loaning money on personal security." Courts have interpreted the incidental powers clause to include, at least, those services that are useful and convenient to the bank or its customers in conducting activities that are expressly allowed under 12 U.S.C. § 24(7). See, e.g., Franklin National Bank v. New York, 347 U.S. 373 (1954); Arnold Tours, Inc. v. Camp, 472 F.2d 427 (1st Cir. 1972).

National banks' participation in the secondary market for agricultural loans and the resulting purchase of Farmer Mac stock falls within such incidental powers. Pursuant to 12 U.S.C. § 24(7), national banks are expressly permitted to loan money. Participating in the secondary mortgage market by, for instance, selling agricultural loans serves to increase the availability of credit to farmers. The sale of agricultural loans to the secondary market is thus convenient and useful to both the bank and its customers.

Although Section 24(7) generally prohibits the purchase of stock by a national bank, we do not believe that the provision was intended to apply to transactions such as purchasing the stock of Farmer Mac. The prohibition was originally enacted to prevent national banks from engaging in what was viewed as speculative activity through stock investment. S. Rep. No. 77, 73d Cong., 1st Sess. 11 (1933). The Comptroller's Office has previously ruled that national banks may buy the stock of a company where the purchase is not motivated by an investment objective, but by participation in facilitating the deposit of securities and the transfer and pledge of bookentry securities. Letter dated 12/19/75 by John E. Shockey, Deputy Chief Counsel (unpublished). See also OCC Interpretive Letter No. 421, [Current] Fed. Banking L. Rep. (CCH) ¶ 85,645 (March 14, 1988). Similarly, the purchase of Farmer Mac stock by national banks is not motivated by an investment objective, but is only intended to permit participation in the agricultural secondary mortgage market.

The legislative history of the Agricultural Act further indicates that Congress assumed that national banks may, and intended them to, participate in the secondary mortgage market by purchasing Farmer Mac stock. Title VIII of that law, which establishes a secondary market for agricultural mortgages, evidences Congress' intent to increase the availability of long-term credit to farmers and ranchers at stable interest rates.

As you point out, national banks' primary role in the secondary market will be as loan originators. The Agricultural Act authorizes Farmer Mac to require loan originators to provide nonrefundable capital contributions as needed. P.L. No. 100-233, Title VII, section 8.7(a)(1), 1988 U.S. Code Cong. & Ad. News (101 Stat.) 1568, 1686. Farmer Mac will then issue voting common stock as consideration for such contributions. The Agricultural Act thus contains a provision that may require national banks to own stock in Farmer Mac as a condition of their participation in the secondary market.

A number of other provisions in the Agricultural Act indicate that Congress intended all types of financial institutions to purchase the stock of Farmer Mac, and thereby participate in the newly formed secondary market. For example, the statute states that "voting common stock [of Farmer Mac] shall be offered to banks, other financial entities, insurance companies, and System institutions under such terms and conditions as the interim board may adopt." Id., section 8.2(a)(9)(B).

The Agricultural Act also provides that five members of the permanent board of directors shall be elected by "holders of common stock that are insurance companies, banks, or other financial institutions or entities." Id., section 8.2(b)(2). Another five members of the board of directors are to be elected

by Farm Credit System institutions, and five are to be appointed by the President. Id. This is to assure that no type of financial institution obtains a disproportionate amount of voting stock. A scheme such as this, which ensures broad distribution of stock and voting rights, indicates Congress' intent to permit all types of financial institutions, including national banks, to purchase the stock of Farmer Mac.

Finally, the Agricultural Act does not indicate or establish a limit on the amount of stock that may be purchased by a national bank. The OCC is obligated to ensure that the activities of national banks are conducted in a manner consistent with safe and sound banking practices. In this respect, the Agricultural Act states that Farmer Mac stock is to be widely distributed to ensure that no institution acquires a disproportionate amount of stock. Id., section 8.2(a)(9)(C). Thus, the Agricultural Act indicates that Congress intended Farmer Mac stock to be widely dispersed among all types of financial institutions, and that an individual bank will not be required to hold a significant amount of stock.

In conclusion, we believe that national banks can purchase Farmer Mac stock in nominal amounts necessary to participate in the program, but any such purchase must be consistent with safe and sound banking practices.

Sincerely,

Paul Allan Schott

Paul Allan Schott
Chief Counsel

Attachment D

States with Ten or More Bank Stockholders in Farmer Mac

State	Number of Bank Stockholders*
Iowa	244
Minnesota	180
Nebraska	177
Illinois	118
Kansas	116
Wisconsin	87
North Dakota	76
South Dakota	59
Texas	56
Colorado	46
Missouri	41
Oklahoma	36
Indiana	26
Arkansas	25
Georgia	24
Montana	24
Ohio	19
Michigan	15
Louisiana	14
Mississippi	14
Wyoming	14
California	12

* These numbers are close approximations, derived from a stockholder list dated March 17, 1989, provided by the Federal Agricultural Mortgage Corporation

Attachment E

IBAA
INDEPENDENT BANKERS ASSOCIATION OF AMERICA

July 18, 1989

O. Jay Tomann
President
Philip J. Vallandingham
President-Elect
David Halberg
Vice President
Edward A. Sheldon
Treasurer
J. R. Nunn
Chairman
Kenneth A. Guenther
Executive Vice President

Honorable Glenn English
U.S. House of Representatives
2206 Rayburn House Office Bldg.
Washington, D.C. 20515

Dear Representative English:

We are deeply concerned that the Farmer Mac secondary market program is losing sight of its statutory structure and purposes, and we urge you to do whatever is necessary to bring about the needed corrections in Farmer Mac before the program proceeds to final implementation.

Farmer Mac was established for the purpose of providing a new source of long-term fixed rate financing to assist farmers and ranchers to purchase agricultural real estate. The statute singled out two sets of institutions, "originators" and "certified facilities" (poolers), who were charged jointly with capitalizing Farmer Mac and carrying out the Farmer Mac program under the direction of the Federal Agricultural Mortgage Corporation (FAMC).

Having contributed about 50 percent of the $22.4 million initial capitalization for Farmer Mac, the local community banks numbering over 1,400 that bought Farmer Mac stock as originators now find that Farmer Mac is developing in a direction that could largely bypass both stockholder originators and the rank-and-file farmers and ranchers that Farmer Mac is supposed to serve. Specifically, the following is happening:

1. The loan pooling function for Farmer Mac is becoming dominated by 2-3 major institutions, with little or no effective competition among those pooling firms.

2. The Farmer Mac standards for poolers were drawn up by a committee of Farmer Mac's board chaired by, and composed exclusively of prospective poolers. No originators were represented. Those standards recognize no ongoing responsibility of the FAMC in maintaining the originator's options for loan servicing and loan participations; instead, the standards sanction the use of master servicers and other procedures that can erode and undercut the originator's prerogatives.

3. Since poolers are authorized to originate loans themselves (as distinguished from buying loans from the approximately 1,500 local banks and others who bought stock strictly to originate loans), poolers can essentially "end run" the statutory structure of Farmer Mac and relegate stockholder originators from whom they take loans to the status of loan "finders" only.

4. The loan underwriting standards have been unnecessarily tightened with respect to situations where a farmer or rancher wishes to finance the purchase of additional acreage for his farm or ranch--despite the fact that this type of financing will be in great demand by rank-and-file farmers and ranchers who would hope to use Farmer Mac.

5. Loopholes were left open in the underwriting standards for financing country residences exceeding the statutory limits for rural housing as well as "hobby" farming activities; this could allow Farmer Mac to develop the volume to "succeed" for poolers of such loans, without their having to reach out and provide substantial new lending to bona fide farmers and ranchers.

To begin correcting these problems with Farmer Mac, we recommend the following:

1. The certified facilities standards should be revised to recognize the originator as a co-equal stockholder participant with the pooler in Farmer Mac, and to include standards for maintaining the originator's full statutory options to service loans and to participate in loans with proper compensation. The originator's prerogatives must be maintained, as the range within which poolers are permitted to originate loans and use master servicers is decided.

2. The FAMC should accept active responsibility for the enforcement of standards for maintaining a stable role for originators in Farmer Mac; such responsibility should include the review of pooler-originator contracts prior to their being placed in effect.

3. The provision allowing a specific parcel of farm real estate that is being financed to qualify on an "owner-operator basis" should be reinstated in the loan underwriting standards.

4. The loopholes in the loan underwriting standards allowing Farmer Mac to be diverted into the financing of country residences exceeding the statutory limit on rural housing loans and of "hobby" farming activities should be closed.

We believe that the extent to which Farmer Mac provides substantial new financing to bona fide farmers and ranchers is highly dependent upon whether a stable role in Farmer Mac for the local stockholder originator is maintained.

Our recommendations are spelled out in greater detail in the attached addendum. We appreciate your interest in resolving Farmer Mac's problems prior to the final implementation of the Farmer Mac program.

Sincerely,

Jack Dickey

Jack Dickey
Chairman
IBAA Agriculture Committee

Testimony of Dorothy J. Acosta
Chairperson, FCA Secondary Market Task Force
Farm Credit Administration

Mr. Chairman and members of the Subcommittee. I am Dorothy J. Acosta, Senior Attorney with the Farm Credit Administration (FCA) and chairperson of the agency's Secondary Market Task Force. The FCA is the independent agency in the executive branch responsible for the regulation and examination of the banks, associations, affiliated service organizations and other entities that collectively comprise what is known as the Farm Credit System. The management of the agency is vested in a board whose three members are appointed by the President subject to confirmation of the U.S. Senate. At the moment there are two vacancies on that board.

As you know, the Farm Credit Administration is charged with the general supervision of the safe and sound performance of the powers, functions, and duties vested in the Federal Agricultural Mortgage Corporation (FAMC) by the Agricultural Credit Act of 1987. I am pleased to be before you today as a representative of the Farm Credit Administration Secondary Market Task Force to discuss standards recently adopted by FAMC from a safety and soundness perspective.

In the view of the FCA professional staff, the major risks to the safety and soundness of FAMC operations lie in the quality of the loans that comprise the pools, the structure of the securities that are guaranteed, and the supporting payment mechanisms. Consequently, the Farm Credit Administration has reviewed and commented to FAMC upon the standards adopted by FAMC to govern underwriting and appraisal, pool diversification and pooler eligibility standards from a safety and soundness perspective. My remarks today reflect, in a general way, the concerns we have communicated to FAMC in our comment letters, which we will be pleased to make available to the Subcommittee.

As a preliminary matter, we wish to make it clear that any reference

by FAMC concerning consultations with the FCA prior to the adoption of the standards should not be read as an endorsement of those standards by the FCA, inasmuch as the standards submitted to the Congress do not address our concerns.

Underwriting Standards

In our estimation, the underwriting standards adopted by FAMC are very general in nature and subject to exceptions for which the board has not provided adequate specific limitation. To illustrate, Standard 9 permits the waiver of any standard if the loan demonstrates compensating strength on one or more of the other standards when such nonconformity and compensating strength are typical of sound borrowers in the particular segment of agriculture in which the loan is made. The standards do not include any specific measures to indicate which nonconformities and compensating strengths will be deemed to be typical of sound borrowers in particular agricultural enterprises.

The FCA staff understands the need for flexibility demanded by the nature of agricultural lending and the business realities of developing a market for securities backed by agricultural real estate loans. We also understand that FAMC may be reluctant to publish benchmark ratios to govern exceptions for various enterprises, so as not to encourage the inclusion of nonconforming loans. However, the failure of the FAMC board to provide adequate guidance governing the granting of exceptions effectively leaves the establishment of standards for any given loan pool to the business judgment of its management. We believe it is unwise for the FAMC board to vest in its management the authority to waive any standard without more

specific limits on that discretion, no matter how conservative the business instincts and intentions of management. We have urged that benchmark ratios be developed by the board for various types of enterprises to serve as an outside limit for exceptions granted under Standard 9. We would leave to the business judgment of FAMC whether these ratios should be published.

The lack of specificity in the standards gives rise to a second concern that FAMC may be placing too much reliance on market forces and the self-interest of poolers and originators and fail to develop effective monitoring mechanisms to ensure that the standards established by FAMC are in fact met. We are not convinced that market forces can be relied on to ensure that the pools will be composed of sound loans. Our experience with the agency securities market and our contacts with security rating agencies suggest to us that investors will rely primarily on the FAMC guarantee and the implied backing of the United States Government.

Nor are we convinced that the self-interest of the poolers and originators in protecting their subordinated participation interests will necessarily provide sufficient assurance of compliance with the underwriting standards. While it would seem that an institution that retains a subordinated interest that absorbs losses first would surely be motivated to originate or purchase only sound loans, it is currently unclear whether subordinated interests retained by poolers or originators will remain on their books or whether these interests will be sold to third parties or securitized. Hence, we believe that FAMC will need to develop strategies for monitoring compliance with its standards that do not rely excessively on persons whose self-interest is presumed to provide sufficient motivation.

Recently, Mr. Henry Edelman, Chief Executive Officer of FAMC, testified that FAMC intends to use computerized risk analysis techniques routinely used by bond insurers, which simulate a series of adverse economic scenarios and their impact on a pool of loans. We are pleased that FAMC intends to use such a "stress test" on each pool before guaranteeing it. In order to ensure meaningful results, we urge FAMC to make certain that the simulation models used for the tests are appropriate for agricultural lending and are not simply borrowed from the models used for the urban mortgage markets. We also suggest that requiring some degree of uniformity in documentation among poolers may be needed to produce consistently reliable results.

Eligibility Standards for Certified Poolers

We find that the FAMC eligibility standards for certified poolers are also general in nature and refer extensively to a Farmer Mac Securities Guide and a standard pooler certification agreement, neither of which is yet available. Since the eligibility standards are so general, the Securities Guide and the pooler certification agreement will be critical in ensuring the safe and sound operation of FAMC. We have also encouraged FAMC to develop guidelines for agreements between poolers and originators that would ensure that FAMC interests are protected.

When the FAMC Securities Guide and the pooler certification agreements are available, the FCA staff's review will focus on the following:

1) the manner in which FAMC will seek to require advances to be made for delinquent payments so that the FAMC guarantee is not triggered prior to the exhaustion of the reserve or the absorption

of loss by the retained subordinated participation interest is structured to provide the equivalent protection of a cash reserve;

2) the structure of the subordinated participation interest and the extent to which it provides the equivalent protection of a cash reserve;

3) the extent to which FAMC provides for recourse in the event of fraud or malfeasance on the part of poolers or originators; and

4) the extent to which provision is made for measures to ensure that any such recourse in the event of fraud or malfeasance cannot be defeated by the transfer or securitization of the subordinated interest.

Mr. Edelman recently testified that FAMC intends "to let the market place and pooler define securities structures and to allow FAMC to test each structure and verify that it works." Thus, it may be that the Securities Guide and the standard agreements will not address all of the issues we had hoped it would with the specificity we would like. While we do not dispute the need for flexibility, to allow for innovation to enhance the market appeal of FAMC-guaranteed securities, we urge FAMC, at a minimum, to develop some guidelines for structuring securities that would identify basic requirements or areas of concern that must be addressed in a manner satisfactory to FAMC.

Capital standards for poolers. The eligibility standards require poolers to have $2 million in "admissible capital" and to be in compliance with their respective regulatory capital requirements. The standards do not define the term "admissible capital." As you know, capital standards and the elements that can be counted as capital vary significantly among the agencies that regulate the various types of institutions that may be

poolers, and some poolers may have no regulatory capital standard at all. As a result, the FAMC capital standard will create an "unlevel playing field" among the various types of poolers. In addition, we do not view the $2 million requirement as a particularly useful measure, since it is an absolute standard unrelated to risk or the size of the operation.

Since it is unclear how FAMC-guaranteed securities will be structured, it is difficult to comment on the adequacy of the capital standards for poolers because we cannot tell what the function of capital is relative to the safety and soundness of FAMC. For example, if securities are structured and agreements written so that the assets of the pooler other than the loans in the pools are not accessible by the investor and FAMC, the level of capital in the pooler is less important than if there is such recourse, especially if the securities are insulated from the insolvency of the pooler. However, in such an instance, the provisions for advance payments in the pooler and guaranty agreements and an adequate level of liquidity in the pooler become especially important in the event loan payments are delinquent. Whatever the function of capital is to be, the $2 million requirement is not a particularly useful measure, since it is an absolute standard unrelated to risk or the size of the operation. It merely has the effect of requiring that poolers be of a certain minimum size in order to participate.

Pool Diversification Standards

The FCA staff does not believe that the pool diversification standards submitted to Congress by FAMC will ensure that the pools are composed of loans of wide geographic and commodity distribution, as required by the

statute. Our analysis indicates that at least 30 different combinations are possible under the proposed geographic distribution standard in which up to 80 percent of a portfolio could be concentrated in two adjacent states. In many cases, the adjacent states may be subject to the same production and economic conditions. At least seven scenarios are possible in which the entire pool would be concentrated in three adjoining states. In five of these, the entire pool could come from an area with a total radius of only a few miles.

In addition, we do not believe that the commodity diversification requirement of the standards will necessarily force a pooler to widen the geographic distribution, since most states with significant agricultural production have sufficient diversification to allow a pool to be drawn from a single state and still meet the commodity diversification standard. This would be true even in such states as Kansas and Oklahoma, where more than half of the cash receipts comes from a single agricultural commodity.

We have encouraged FAMC to adopt a further refinement of the pool diversification standards to ensure that the geographic concentrations possible under the standards do not occur.

Summary

In summary, our major safety and soundness concerns with respect to the standards are:

1) lack of specificity in the underwriting and pooler eligibility standards and the extent to which management can waive the standards without specific limitation by the FAMC board;
2) absence of a meaningful capital standard for poolers;

3) lack of effective monitoring mechanisms and the apparent excessive reliance on market forces and the presumed self-interest of the participants to ensure that standards are met;

4) the ineffectiveness of the geographic and commodity diversification standards for ensuring the diversity required by the statute; and

5) the need for guidelines for structuring securities and agreements that will ensure that the interests of FAMC are protected.

While many of our concerns could be addressed in the Securities Guide and the standard agreements, we have not yet seen these documents or a business plan developed by FAMC that reassures us that effective monitoring mechanisms will be implemented. While we understand that FAMC is in a start-up mode and appreciate the size of the task facing FAMC in gaining market acceptance for a new product, we believe there likely will be significant safety and soundness problems later if the issues we have raised are not appropriately addressed at the outset.

The FCA staff hopes that its comments will be helpful in your review of the standards adopted by FAMC and stands ready to answer any questions the Subcommittee may have.

(Attachments follow:)

Acct. A. 10

Farm Credit Administration

1501 Farm Credit Drive
McLean, Virginia 22102-5090
(703) 883-4000

September 1, 1989

Mr. Henry Edelman
Chief Executive Officer
Federal Agricultural Mortgage Corporation
2021 K Street, NW Suite 306
Washington, DC 20006

Dear Mr. Edelman:

We have reviewed the underwriting and appraisal standards adopted by the board of the Federal Agricultural Mortgage Corporation (FAMC) and submitted to Congress on June 30, 1989. We have also reviewed the pool diversification standards submitted to the Congress on July 18, 1989, which were provided to us on July 21, 1989. Our comments on both sets of standards follow.

Underwriting and Appraisal Standards

The safety and soundness concerns communicated to you in our letter of June 26, 1989, are heightened by your failure to address them in the standards submitted to Congress. Indeed, the standards appear to have been relaxed further in some respects. For example, the revised draft standards on which we commented permitted the waiving of any standard except the current ratio when the loan demonstrates compensating strengths and the nonconformity and compensating strengths are typical of the financial condition of sound borrowers in the particular segment of agriculture. The underwriting standards sent to Congress would allow even the current ratio to be waived.

In particular, the elimination of the current ratio as the one standard that could not be waived heightens the concern expressed in our June 26, 1989 letter about the lack of board limitation on the discretion of management to waive standards. We would urge you to develop board-approved benchmark ratios for loans financing particular agricultural enterprises as an outside limit on the degree of nonconformity that can be accepted in the pools. We express no opinion on whether such ratios should be published.

In addition, we reiterate our concern that the 1:1 current ratio may be too liberal in view of the types of agricultural assets that are sometimes included in the definition of "current assets." Our concern is also attributable to the fact that the proposed valuation method (which would value the assets at the lower of cost or market value until such time as market value can be readily established) would permit unearned profits in current assets to be factored into the calculation.

Pool Diversification Standards

We do not believe that the pool diversification standards submitted to Congress will ensure that the pools are composed of loans of wide

geographic and commodity distribution, as required by the statute. Our analysis of the standards indicates that at least thirty different scenarios are possible under the proposed geographic distribution standard in which up to 80 percent of a pool could be concentrated in two adjacent states. In many cases, the adjacent states are subject to the same production and economic conditions. At least seven scenarios are possible in which the entire pool could be concentrated in three adjoining states. In five of these, the entire pool could come from an area with a total radius of only a few miles.

Nor do we think the commodity diversification requirement will necessarily force a pooler to widen the geographic distribution, since most states with significant agricultural production have sufficient diversification to allow a pool to be drawn from a single state and still meet the commodity diversification standard. This would be true even in such states as Kansas and Oklahoma, where more than half of the cash receipts come from a single commodity.

To ensure the intended geographic diversification, additional requirements could be superimposed on existing standards, such as a requirement either (a) that loans come from noncontiguous production regions or (b) that loans come from at least two states in each region with no more than 50 percent coming from any two or three adjoining states. Another alternative might be to require at least one noncontiguous region having at least one-third of the loan volume to be included. There may be other alternative requirements that, when added to the existing requirements, would result in sufficient geographic diversity to satisfy the statutory standard and reduce the risks associated with single industry lending to acceptable levels. We urge FAMC to consider adopting additional requirements to strengthen existing standards or developing new and stronger standards that will be more effective in ensuring the geographic and commodity diversification intended by the statute and required in order to contain concentration risk within acceptable limits.

Monitoring Compliance with the Standards.

On June 28, 1989, we also transmitted a letter commenting on the draft revised Certified Facility Eligibility Standards in which we expressed concern that the standards did not appear to make adequate provision for monitoring compliance with underwriting and appraisal standards. The quality of the loans and the supporting appraisals is critical to the safe and sound operation of FAMC. Excessive reliance on poolers for monitoring compliance with these standards without proper oversight by FAMC could constitute a threat to the safety and soundness of FAMC operations.

With respect to all of the standards, we urge FAMC to develop effective monitoring strategies and mechanisms that do not rely primarily upon market forces or the presumed self-interest of poolers and originators to ensure that sound loans are made and that securities and supporting payment mechanisms are structured to protect the interests of FAMC. We are skeptical that market forces will provide adequate assurance that sound loans will be included, as our experience with the agency securities market and our contacts with rating agency officials lead us to believe that investors will rely primarily on the FAMC guarantee and a perception of

implied backing by the United States Government. Nor do we think that the self-interest of poolers and originators that retain a subordinated interest will necessarily result in pools composed of sound loans, since it is unclear at this time whether these interests will actually be retained by the pooler or originator themselves, or sold to third parties or securitized.

Securities Guide and Standard Agreements.

As you develop your Securities Guide and standard pooler agreement, we urge you to require inclusion of provisions that will adequately protect the interests of FAMC and permit some recourse in the event of fraud, malfeasance or noncompliance with the standards. We would also urge you to consider adopting appropriate measures to ensure that such recourse is not defeated by a transfer or securitization of the subordinated interest. Our review of the Securities Guide and the standard pooler agreement will focus on these issues and the provisions for advancing payment on the securities in the event loan payments are not made in a timely manner, so that the FAMC guarantee is not triggered prior to the exhaustion of the cash reserve or the absorption of loss by the subordinated interest.

In addition, we urge you to consider developing a standard agreement between pooler and originator and guidelines for securitization of the subordinated interest that will include provisions needed to protect the interests of FAMC in the timely payment of the securities and permit adequate recourse for FAMC in the event of fraud, malfeasance or noncompliance with standards.

Congressional Testimony.

As you may know, the FCA has been asked to testify at the September 12, 1989 hearing before the Policy Research and Insurance Subcommittee of the House Committee on Banking, Finance and Urban Affairs. We expect that our testimony will highlight the concerns we have communicated to you in our comment letters, which we will make available to the subcommittee upon request.

If you have questions concerning these comments or wish to discuss them further, please contact Larry W. Edwards, Office of Examination at 883-4229, Dorothy J. Acosta, Office of General Counsel at 883-4020, or me at 883-4160.

Sincerely,

David C. Baer, Director
Office of Examination

cc: John R. Dahl
Chairman of the Board

Farm Credit Administration

1501 Farm Credit Drive
McLean, Virginia 22102-5090
(703) 883-4000

June 28, 1989

Mr. Henry D. Edelman
Chief Executive Officer
Federal Agricultural Mortgage Corporation
1667 K Street, NW Suite 306
Washington, DC 20006

Dear Mr. Edelman:

The Farm Credit Administration (FCA) has reviewed the draft Certified Facility Eligibility Standards (Eligibility Standards) proposed by the Federal Agricultural Mortgage Corporation (FAMC) that were discussed at a public meeting held on June 14, 1989, and offers the following comments.

General

1. The Eligibility Standards are not definitive and refer extensively to the "Farmer Mac Securities Guide" (Securities Guide) as well as to a "standard Farmer Mac pooler certification agreement" (pooler certification agreement) to provide more detailed instructions and descriptions of a number of areas. In particular, the Securities Guide will set forth FAMC's official policies with respect to certified facilities. Since neither document has been developed yet, it is difficult to provide a complete assessment of the Eligibility Standards at this time. Presumably these documents will be designed to protect the interests of FAMC and will contain requirements for structuring the securities that FAMC will agree to guarantee and other requirements (including eligibility and performance requirements for master servicers and direct services, and possibly including required contractual provisions for agreements between poolers and originators). If these assumptions are correct, these documents may address many of the FCA's comments on the Eligibility Standards set forth in the discussion which follows and may generate additional comments. Accordingly, we are interested in reviewing the Securities Guide and pooler certification agreement as soon as they are developed so that any additional comments can be communicated to you as early as possible.

2. While the Eligibility Standards properly address a variety of ongoing monitoring responsibilities placed upon certified facilities (poolers), attention should also be focused upon how FAMC will ensure that certified facilities in fact perform their monitoring responsibilities. Reliance on pooler certification alone would provide insufficient assurance that FAMC underwriting and servicing standards are being met.

Capital requirements. The capital requirements for certified facilities require further refinement. As currently written, the Eligibility Standards require certified facilities to maintain $2 million in admissible capital and meet or exceed the capital standards established by the institution's regulatory agency or agencies. This capital requirement is insufficiently related to the pooler's risk, places undue reliance on capital standards which differ significantly among regulatory agencies, and does not define admissible capital. The proposed capital standard leaves open the possibility that some certified facilities will be required to meet only the $2 million standard, since some poolers may not be subject to a regulatory capital standard. In addition, we believe it important that FAMC's definition of admissible capital be specified in the Eligibility Standards. We are interested in learning the rationale that underlies the selection of the proposed capital standard.

In addition to capital requirements, some criterion that measures the financial condition of poolers is needed to protect against risks such as cash-flow risk, interest rate risk, and other investment risks.

Pooler certification agreement. The Eligibility Standards state that the pooler certification agreement will incorporate by reference the Securities Guide, which is not yet developed. Presumably the pooler certification agreement will require advances to be made for delinquent loan payments and will address the manner in which these advances will be made, and the entity required to make them, so that the FAMC guarantee is not triggered prior to the exhaustion of the reserves or the absorption of loss by the retained subordinated participation interests. We are interested to learn how this result will be achieved. We are also concerned that a retained subordinated participation interest be structured so that it provides FAMC the equivalent protection of a cash reserve.

Reporting requirements. The Eligibility Standards do not specify pooler reporting requirements. The FCA believes that the collection of loan performance information by pool is critical to the effective monitoring of FAMC's contingent liability. Since poolers will be subject to various regulators, it appears necessary to specify a uniform reporting format in order to obtain meaningful aggregate data. The FCA call report for FAMC will require loan performance information to be reported by pool in accordance with performance categories set forth in 12 CFR Part 621. FAMC may also require additional information to be reported for its own business purposes. Poolers should be put on notice of the reporting requirements that will be imposed.

Managerial ability. The Eligibility Standards do not provide sufficient guidance to potential poolers regarding the criteria to be used by FAMC to assess whether the poolers possess managerial ability to perform the functions listed in the Eligibility Standards.

Conflict of interest. The Eligibility Standards specify that a pooler's quality control procedures should include provisions that protect against conflicts of interest in the loan origination process. We believe it also necessary to require that these quality control procedures include protection against conflicts of interest that may arise in connection with

the servicing of the mortgage loans placed in a pool, as well as in the issuance and administration of the securities that are guaranteed.

As we have already indicated, we may have additional or different comments when we have reviewed the Securities Guide, the structure of the securities to be issued, the pooler certification agreement, and the agreements between poolers and originators.

If you have questions concerning these comments, please contact Larry Edwards, Office of Examination, at 883-4229, Dorothy J. Acosta, Office of General Counsel, at 883-4020, or me at 883-4160.

Sincerely,

David C. Baer, Director
Office of Examination

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Farm Credit Administration

1501 Farm Credit Drive
McLean, Virginia 22102-5090
(703) 883-4000

June 26, 1989

Mr. Henry Edelman
Chief Executive Officer
Federal Agricultural Mortgage Corporation
2021 K Street, NW Suite 306
Washington, DC 20006

Dear Mr. Edelman:

As we recently agreed, the Farm Credit Administration (FCA) offers its comments on the draft underwriting standards as revised by the Federal Agricultural Mortgage Corporation (FAMC) in response to comments made at the public forum on May 5, 1989.

As a preliminary matter, the lack of specificity in the standards in a number of areas prevents the FCA from offering definitive comments on the standards at this time. We understand that FAMC will be providing greater detail in manuals and guidelines that are presently being developed, and we may have additional comments as these are developed. We are more concerned that board policy be set forth in sufficient detail to provide adequate guidance to management regarding underwriting standards than we are about the form in which the standards appear. Therefore, the comments below regarding lack of specificity are directed to the need for more definitive board guidance.

Our comments on the revised standards are set forth below.

General

We recommend that the standards define more specifically the terms used in the required ratios. In some cases we are unable to evaluate the suitability of the ratios for various enterprises until we know with greater certainty how these terms are to be defined. For example, while the commentary clarifies the treatment of livestock for the purpose of determining the current ratio, "current assets" is not defined, and wide agreement in the industry about what should be included is lacking.

Standard 4

A current ratio of 1:1 may prove to be too liberal for agricultural enterprises in which current assets constitute a large proportion of total assets, since it implies a zero equity in current assets.

Standard 6

This standard needs to be more definitive in setting forth minimum acreage and receipts requirements for farms. Distinguishing between part-time farms and rural residences will be important in determining which standards to apply.

Standard 7

1. More explicit guidance is needed concerning the circumstances under which loan agreements, personal liability, additional collateral, and title and casualty insurance must be required. We view these requirements as important risk containment measures and may have further comments when it becomes clear under what circumstances each of these requirements must be imposed.

2. We are concerned that allowing loans with balloon payments to be included in the pool may create a serious cash flow problem. If for any reason the borrower is unable to obtain refinancing to meet the final loan payment and the term of the loan coincides with the maturity of the security, it may not be possible to retire the security at maturity. If for some reason loans are written with shorter maturities than the security, the pooler may experience serious cash flow problems during the life of the security if the reserve is insufficient. At a minimum, a limitation should be placed on the volume of balloon payment loans that can be included in a pool, to minimize the risk of a default on the security.

Standard 8

The standards need to describe the adjustments that will be made to the standards of the Federal National Mortgage Association for use as underwriting standards for rural housing loans. We may have additional comments when these adjustments are set forth with greater specificity.

Standard 9

We note that in lieu of setting specific standards for administering exceptions to the 50 percent ratio for traditionally highly leveraged but highly profitable operations, the revised standards would allow FAMC to accept loans that do not conform to one or more of the standards (except the current ratio) on a pool-by-pool basis when: (1) the loans demonstrate compensating strengths; and (2) the loans are made to producers of particular agricultural commodities or products in a segment of agriculture in which such nonconformance and compensating strength are typical of the financial condition of sound borrowers.

While we appreciate the difficulty of developing underwriting standards for the various types of agricultural enterprises and understand the need for flexibility, the lack of definitive standards for administering the acceptance of nonconforming loans concerns us. We understand that FAMC may be reluctant to encourage nonconforming loans by publishing such standards.

However, we believe that more definitive guidance from the board of FAMC governing the acceptance of nonconforming loans is needed, inasmuch nonconforming loans are likely to involve riskier enterprises, such as developing orchards, various confinement operations, and commodity operations that are facility-intensive. Also, we recommend that the volume of nonconforming loans that will be permitted in the pool be subject to appropriate limitations.

If you have questions or wish to discuss these comments or other matters relating to the operations of FAMC, please contact Larry Edwards, Office of Examination, at 883-4229, Dorothy Acosta, Office of General Counsel, at 883-4020, or me at 883-4160.

Sincerely,

David C. Baer, Director
Office of Examination

United States General Accounting Office

GAO Testimony

For Release
On Delivery
Expected at
10:00 a.m. EST
Wednesday,
September 27,
1989

Issues Surrounding Underwriting Standards Developed by the Federal Agricultural Mortgage Corporation

Statement of
John W. Harman, Director, Food and
Agriculture Issues
Resources, Community, and Economic
Development Division

Before the
Subcommittee on Conservation,
Credit and Rural Development
Committee on Agriculture
House of Representatives

GAO/T-RCED-89-71

GAO Form 160 (12/87)

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our recent work concerning issues facing the Congress and the Federal Agricultural Mortgage Corporation--Farmer Mac--as they develop and implement the new secondary market for agricultural real estate and rural housing loans. We have been working on many issues related to this new market since its early formative stages. Our most recent work focuses on issues and concerns related to Farmer Mac's underwriting and other standards that have been submitted for Congress' review. This work was done at the request of the Subcommittee on Policy Research and Insurance, House Committee on Banking, Finance and Urban Affairs, and the Subcommittee on Agricultural Credit, Senate Committee on Agriculture, Nutrition and Forestry. The testimony I am presenting today is the same as I presented on September 12, 1989, before the Subcommittee on Policy Research and Insurance.

My testimony includes information on (1) secondary markets in general and the overall issues that need to be considered in developing and implementing a secondary market for agricultural real estate and rural housing loans, (2) underwriting and risk management in Farmer Mac, and (3) concerns and issues we have identified during our review of the current Farmer Mac standards submitted to Congress.

BACKGROUND

The Agricultural Credit Act of 1987 (P.L. 100-233, Jan. 6, 1988) established Farmer Mac as a federally chartered instrumentality of the United States and an institution of the Farm Credit System (FCS). The purpose of Farmer Mac is, among other things, to encourage capital market participation in agricultural real estate and rural housing lending. This increased participation is intended to provide (1) lenders more lending capacity by allowing them to sell their farm real estate and rural housing loans through a secondary loan market and (2) farmers and ranchers more long-term credit at stable interest rates, including fixed rates.

The act required Farmer Mac to submit certain underwriting standards to the Congress for review within 120 days after the first meeting of the permanent board of directors, which was March 2, 1989. Farmer Mac submitted the first of the required standards--those that govern the quality of the loans--on time on June 30, 1989. On July 18, 1989, Farmer Mac submitted another set of standards to govern loan pool makeup, that is, the maximum size of any given loan, minimum number of loans, and types and geographic distribution of loans. Farmer Mac also provided the Congress on June 30, 1989, with standards addressing certifying qualifications of organizations that will be permitted to act as loan poolers. The act required that the first two sets of

standards would not take effect before the later of 30 legislative or 90 calendar days beginning on the date the standards were submitted for review. It has no provision, however, for when the certification standards take effect. Some potential market participants and Farmer Mac officials with whom we have spoken have hopes that the first pool of loans can be issued by late this year or in early 1990.

During our review of the Farmer Mac underwriting standards, we interviewed private and government individuals and officials concerned with secondary markets in general and Farmer Mac in particular. We interviewed bankers; insurance company, investment house, and investment-rating agency representatives familiar with secondary market and farm credit issues; and officials from several other organizations, including the American Institute of Certified Public Accountants, Farm Credit Administration, Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac), the American Bankers Association (ABA), the Independent Bankers Association of America, the American Society of Farm Managers and Rural Appraisers, and the Federal Financial Institutions Examination Council.

We also interviewed selected Farmer Mac stockholders that bought enough stock to become loan poolers and those that bought only enough to become originators in the Farmer Mac market. In addition, we obtained informal comments from Farmer Mac

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representatives as we performed our work and considered them in finalizing our observations.

ISSUES CONCERNING THE DEVELOPMENT AND IMPLEMENTATION OF A SECONDARY MARKET FOR AGRICULTURAL REAL ESTATE LOANS

Our first effort in the area of secondary markets for agricultural real estate loans resulted in a July 1987 report[1] to Representative Richard H. Lehman. This report provides information on secondary markets, in general, including purposes those markets have served in the past, and major issues meriting further attention in determining the effects of a secondary market for agricultural real estate loans on farmers, lenders, and the federal government. Our latest report,[2] issued on May 5, 1989, to Representative Lehman and three other requesters, provides information on underwriting standards for secondary markets, in general, and discusses key issues facing Farmer Mac in developing its underwriting standards.

In our July 1987 report, which is a primer on secondary markets, we raised five issues that we believed merited further consideration in the secondary market debate taking place at that

[1]Farm Finance: Secondary Markets for Agricultural Real Estate Loans (GAO/RCED-87-149BR, July 17, 1987).

[2]Federal Agricultural Mortgage Corporation: Underwriting Standards Issues Facing the New Secondary Market (GAO/RCED-89-106BR).

time. Most of those issues are still the subject of much debate today. Some were incorporated in the Agricultural Credit Act as future Farmer Mac studies to be performed by GAO. These studies focus on (1) implementation of Farmer Mac and its effect on producers, lenders, FCS, and the capital markets; (2) the feasibility of an agricultural real estate loan secondary market without a Farmer Mac guarantee; and (3) the feasibility of expanding Farmer Mac's authority for the sale of securities based on a pool of loans made to farm-related and rural small businesses. Another issue is the focus of today's hearings as you review the underwriting standards that will determine what loans will be eligible to be sold in the new secondary market. In appendix I, we provide a description of each issue as it appeared in our 1987 report.

In our May 1989 report we broadly defined underwriting standards as criteria, or guidelines, used to (1) limit the type and amount of risk of loss permitted in a financial portfolio and (2) establish methods to insure against loss from those risks. In secondary markets such standards are generally used to establish the qualifications that individual loans must meet if they are to be eligible to be purchased and packaged into pools for resale. Standards for pools must therefore be flexible enough to evolve over time to accommodate changes in economic factors, risk management techniques, and other factors that affect the secondary market. However, they must also be constant in their ability to

ensure that only loans that meet acceptable risk parameters are included in the pools. Appendix II provides further information from our May 1989 report on risks in secondary mortgage markets and risk-bearing mechanisms and strategies.

ISSUES RELATING TO UNDERWRITING AND RISK MANAGEMENT IN FARMER MAC

Agricultural real estate is a new frontier for a national secondary market. The characteristics of agriculture make these loans more risky than housing loans in secondary housing markets. In terms of the homogeneity of the land and structures, use of the land and structures, and sources of cash flows, agriculture is much more risky than housing that has a diversity of income streams, as well as building standards and ordinances that protect the value of housing. Therefore, many decisions about this new market necessarily will be based on trial and error--a method that has much potential risk.

In our May report, we stated that several issues merited consideration during the legislative review process for Farmer Mac underwriting standards. These issues are:

-- What are the implications of the geographical diversity requirements in the act?

-- What are the implications of agricultural commodity diversity requirements in the act?

-- Can state-of-the-art real estate appraisals provide enough assurance in verifying cash-flow potential and agricultural real estate values to enable prudent loan-making decisions?

-- How would the use of lender or pooler subordinated participation interests versus cash reserves affect the federal government's financial risk on securities guaranteed by Farmer Mac?

-- Will the prescribed risk-based fees be adequate for Farmer Mac?

-- What implications do the Securities and Exchange Commission (SEC) registration and disclosure requirements have for Farmer Mac-guaranteed securities?

-- What effect will the loan-to-value ratio in the act have on government risk?

-- What effect will rural housing provisions have on Farmer Mac-guaranteed securities and how will such loans be packaged?

Many of these issues relate primarily to potential government risk. Some of the questions must be addressed as the new market is being implemented, while others need to be addressed as the detailed underwriting standards for the market are developed. Appendix III includes excerpts from our May 5, 1989, report providing a further discussion of each issue.

CONCERNS WITH FARMER MAC'S UNDERWRITING STANDARDS

In creating Farmer Mac, the Congress established several broad expectations for Farmer Mac, including (1) limiting the government's risk exposure from Farmer Mac; (2) increasing the availability of long-term agricultural credit at stable interest rates by providing greater liquidity and lending capacity to lenders for diversified pools of agricultural real estate loans; (3) ensuring that small originators and small loans are not discriminated against in the market; (4) enhancing the ability of individuals in small rural communities to obtain financing for moderately priced homes; and (5) getting the market operating quickly.

As mentioned earlier, Farmer Mac has submitted three sets of standards and Farmer Mac officials told us that these standards represent the guiding principles for the market's future operations. Farmer Mac will also issue a Securities Guide containing, among other things, minimum requirements for various

aspects of the Farmer Mac program and more detailed criteria to guide the market's operation. Under the Agricultural Credit Act, Farmer Mac is not required to submit the Securities Guide for Congress' review. As a result, there is no assurance that some outstanding questions will be addressed in it. Our views today, therefore, are based on our understanding of the current underwriting standards and not on assumed or planned standards or more detailed criteria that are not yet formalized or available for review.

Also, I would like to state that the concerns I will mention today have not necessarily been endorsed by potential market participants, but they represent our views that were formed after having talked to potential market participants and others familiar with secondary markets and the farm credit area. In developing our views, we necessarily have considered the Congress' concern that it limit the government's potential risk to some extent. It is not unusual that market participants concerned about risk and benefits to them, both individually and as organizations, may not totally agree with our overall concern for the government's potential risk exposure. Some believe that the government will ultimately accept some of the risk in the market through support mechanisms such as we have recently seen in the savings and loan and the FCS bail-outs.

On the basis of our examination of the enabling legislation and the Farmer Mac standards, and discussions with a wide variety of individuals and officials from both the private sector and the government, several issues and concerns merit further consideration by the Congress during the legislative review period to ensure that the loan criteria, market structure, and risk parameters satisfy Congress' broad expectations. In this context, I would like to present our views on the Farmer Mac underwriting standards.

Specifically, we raise concerns related to key terms and concepts, exceptions to the standards, consistency of financial information, financial ratios, standardized market operating agreement, regulatory approaches, pool diversification standards, appraisal standards, and standards for rural housing loans.

Key Terms and Concepts

It is important that key terms and concepts governing the eligibility of loans be adequately defined to ensure that the loans in a pool have met certain basic criteria that (1) allow only loans of known and comparable risk into the pool and (2) ensure that Congress' broad expectations are met. Some terms and concepts included in Farmer Mac's standards are undefined.

Throughout the standards Farmer Mac does not specify accounting practices to be used in calculating financial ratios and preparing financial statements. Different accounting interpretations could result in loans with noncomparable risk. I will discuss broader implications of this later. Credit underwriting standard 6 illustrates how undefined terms could potentially result in loans in the pool that do not meet Congress' expectations. This standard requires that the property financed meet the minimum acreage or minimum annual receipts requirements to be established by Farmer Mac, but does not elaborate on the key terms "minimum acreage" or "minimum annual receipts." For purposes of oversight, such a standard provides little assurance of what borrowers Farmer Mac will ultimately include in the market.

Exceptions to the Standards

While it is necessary to allow for flexibility in loan underwriting standards to provide the capability to react to nonconforming but acceptable situations, it is also important that the exception does not become the rule because that could create a situation where the market is potentially guided by a case-by-case subjective judgment that ultimately may not provide the risk protection intended under broader pooling criteria. The credit underwriting, loan diversification, and certified facility standards include broad language to allow for exceptions to and/or

broader interpretations of the standards. For example, credit underwriting standard 9 provides that

> "Farmer Mac may, on a pool-by-pool basis, accept loans that do not conform to one or more of the preceding standards when: (a) those loans demonstrate compensating strength on one or more of the standards to which they do conform; and (b) those loans are made to producers of particular agricultural commodities or products in a segment of agriculture in which such non-conformance and compensating strength are typical of the financial condition of sound borrowers."

Several financial sector officials and potential market participants indicated that Farmer Mac could better ensure that the exception would not become the rule by establishing some limitations on the absolute amount of exceptions allowed in any given pool.

Consistency of Financial Information

As is the case with terms and concepts, it is important that the financial information in each loan application be reported in a consistent and comparable manner to better ensure comparable and known risks in the loan pool. Many potential market participants we talked to acknowledged that the underwriting standards do not

require financial information in a manner that ensures such consistency. As a result, loans could be included in pools that may not have comparable or even known risk characteristics. For example:

-- Standardized accounting terms and methods are not required. These terms and methods are necessary to ensure consistency of financial information used to make loan decisions that ultimately determine the risks in the loan pools. Farmer Mac does not require borrower's financial statements supporting loan applications to follow specific accounting principles such as generally accepted accounting principles (GAAP). The lack of reliance on GAAP or some set financial disclosure practice makes it very difficult to compare financial information on all loans in a loan pool. The Farm Financial Standards Task Force[3] is currently completing a national study of the use of accounting conventions in agricultural finance. The task force found a lack of consistency in the use and understanding of accounting practices and terms used in agriculture and plans to issue its report in November 1989, which it hopes will lead to more consistency in the presentation of financial information.

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[3]The task force is sponsored by the ABA and comprised of members from many groups, including the academic community, commercial banks, insurance industry, FCS, accounting profession, and regulatory agencies.

-- Projected financial statements are not specifically required. Projected financial statements are important because they represent how the farmer plans to carry out the farming operation during the projected period. These statements are particularly important if the farmer plans to change cropping or production systems on land he currently farms, or buys new land and is farming it for the first time. As part of projected financial statements, a cash-flow analysis is a valuable tool because it provides lenders with a detailed repayment plan of how the farmer plans to meet currently maturing debt obligations. Most lenders we talked with told us that they currently prepare cash-flow analyses as an integral part of their credit approval processes. They also told us that it is imperative to have 3 years of tax returns together with the other financial statements required by the standards to prepare reliable cash-flow analyses. Farmer Mac does not require borrower tax returns to be submitted with loan documentation. The "forward looking" approach, which predicts future financial performance, is missing in the standards.

Financial Ratios

It is important that Farmer Mac fully evaluate the potential effects of its standards and accompanying financial ratios to

determine if they will have intended effects. Financial ratios are used together with other criteria as determinants of the ability of a loan to qualify to be sold into the Farmer Mac secondary market. Some examples of potential unintended effects follow.

-- Credit underwriting standard 5 requires that the real estate being financed have a minimum 1 to 1 cash flow to debt service coverage ratio, except for loans in which (a) the borrower's principal residence is on the property securing the loan and (b) the proforma debt coverage ratio of the entity being financed has for the last 3 years been no less than 1.5 to 1. We have been told that a large portion of agricultural real estate loans being made to farmers today are for add-on purchases. Some potential market participants have expressed concerns that it is unreasonable to require such add-ons to meet the cash flow to debt service coverage ratio of 1 to 1. They pointed out that in agriculture, as well as in the rental housing markets, new purchases generally do not economically cash-flow in the first few years. One way to accommodate this phenomenon may be to require more stringent ratios and criteria for the overall farm operation.

-- Some lenders told us that the standards may allow loans to be based on the value of an unusually high-priced residence on the property, and not necessarily the ability

of the property to carry debt based on its production capability. To illustrate this point, one banker told us that a farmer had off-farm income that supported the construction of a residence on his farm at a cost that exceeded the value of an average house in the area by about $100,000. The banker also told us that, when the farmer defaulted and the farm was offered for sale, the buyers were only willing to pay the average value of a home in the area; therefore the bank lost about $100,000. Some lenders said that to avoid liquidity problems that could result in losses upon default, Farmer Mac may want to consider limiting the allowable dollar value of the house in determining the ultimate loan amount for the entire property or allowing only a certain percentage of off-farm income to be used to qualify as income supporting the loan application.

Standardized Market Operating Agreement

The marketing agreement between the lender and pooler can determine exactly who bears the ultimate risk in the market. This agreement basically spells out the rights, responsibilities, and liabilities--including recourse provisions--for lenders and poolers. If such agreements are not done properly and consistently even small changes in language can result in huge liability shifts. Most potential market participants that we

talked to acknowledged these risk implications. The Farmer Mac certified facility standards are very general in defining the framework for a standard market operating agreement between lenders and loan poolers. In addition,

-- Recourse provisions of the subordinated participation interests[4] have not been addressed in the standards. This one element will be a pivotal point that will determine if and when the government has to provide funds to keep the market afloat in a recession scenario such as agriculture experienced in the mid-1980s. Appendix III provides a broader discussion of the subordinated participation interest issue.

-- Several lenders and others we talked to raised concerns that, without a market agreement specifically geared to making sure smaller lenders with lower volume loans could participate in the market, small lenders may be either excluded through competitive pressures or receive less than desirable market agreements from individual poolers.

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[4]Subordination participation interests are created when a pooler and/or lender retains a portion of a mortgage pool and the holders of the retained portion do not receive principal and interest payments (subordinated payments) until after all other investors have received their payments (senior payments).

Regulatory Approaches

According to many sources we talked to, the potential market participants could be regulated by several different regulators and this could result in some participants being regulated more strictly than others. This could result in inhibiting competition and actually excluding some participants from the market. For example, there is some concern that commercial bank regulators may require significantly more capital to be held against Farmer Mac loans than insurance company regulators may require. Both banks and insurance companies have acknowledged this issue and agree that banks, under certain scenarios, could be essentially excluded from the market or have to act as mortgage bankers by simply originating mortgages and not retaining any part of the loan. While Farmer Mac standards require that poolers have at least $2 million in capital, they do not specify capital requirements in the sense of commercial banking's safety and soundness regulations. It is also probable that appraisals will be regulated by several different regulators, posing a similar concern. Farmer Mac needs to examine the potential implications of differing regulatory approaches on all market participants and how such approaches may affect Farmer Mac's activities.

Pool Diversification Standards

The Agricultural Credit Act specified that each pool of loans meet diversification requirements including that each pool be secured by agricultural real estate that is widely distributed geographically and is used to produce a wide range of agricultural commodities. These standards are important because they can determine the overall risk that will exist in any given pool and may also affect the market's structure. The current diversification standards may allow poolers to potentially bypass the geographic diversification requirement of the act by drawing loans from the intersection of three contiguous regions, which could reduce the diversity of individual pools due to similar agricultural commodities and climatic conditions in these areas. Farmer Mac could prevent this by disallowing the formation of pools of loans that come from such a limited geographic area.

Appraisal Standards

Appraisal standards are a key part of the loan-making decision because they govern the valuation of property and cash flows that will be used as a basis for the collateral and earning capacity to repay the loan in case of default. Farmer Mac's appraisal standards rely, in large part, on Uniform Standards of Professional Appraisal Practice for such items as appraisal definitions, education requirements, and appraisal reporting developed by the

Appraisal Foundation[5]. Farmer Mac standards also have broad provisions for monitoring the implementation of the standards.

While we did not specifically evaluate Farmer Mac appraisal standards, we noted that they do not come under the appraisal provisions of the recently passed Financial Institutions Reform, Recovery, and Enforcement Act of 1989. The act requires appraisal standards at the federal level to ensure that loans or transactions requiring appraisals have appraisals performed in accordance with standards to be developed under the purview of the Federal Financial Institutions Examination Council--an organization that coordinates the activities of agencies that regulate depository institutions, such as commercial banks, credit unions, and savings and loan institutions. It appears that loans made by insurance companies and FCS institutions--potential major participants in the new market--will not come under the appraisal provisions of the 1989 act.

Because the Congress studied the appraisal issue and decided on federal involvement in aspects of the appraisal industry that potentially cover at least some loans sold into the Farmer Mac secondary market, we believe additional consideration needs to be

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[5]The Appraisal Foundation is a nonprofit entity established by U.S. and Canadian appraisal associations to help ensure that appraisers are qualified to offer their services to financial institutions and to the real estate industry.

given to how the Congress wants to assure itself that all loans in the Farmer Mac market are appraised adequately.

Standards for Rural Housing

Credit underwriting standard 8 provides that Farmer Mac will adopt credit underwriting standards similar to those of Fannie Mae, adjusted to reflect the usual and customary characteristics of rural housing. The standard establishes a 75-percent loan-to-value ratio that can be met in part with private mortgage insurance.

Farmer Mac has not identified specific Fannie Mae standards that will be used, nor what adjustments will be made to reflect the usual and customary characteristics of rural housing. We believe that Farmer Mac standards should include more criteria on what the rural housing loans will look like, so that the Congress has a better idea of the risk parameters for that market and the adequacy of the 75-percent loan-to-value ratio set in the standards.

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In summary, Mr. Chairman, many of the issues I discussed today relate to potential government risk. We believe that the Congress had an expectation to limit the government's potential risk exposure from Farmer Mac. Some of the issues and questions raised

must be addressed as the new market is being implemented, while others need to be addressed as the detailed underwriting standards for the market are developed. Certainly, Farmer Mac has the potential to offer a unique new element to the nation's agriculture credit delivery network.

We hope that the observations provided today will aid the Subcommittee's oversight of Farmer Mac's activities. We look forward to working with your Subcommittee and Farmer Mac to ensure that this new secondary market for agricultural real estate and rural housing loans fulfills the expectations laid out in the Agricultural Credit Act of 1987.

This concludes my prepared statement. My colleagues and I will be happy to respond to any questions you may have.

(Attachments follow:)

APPENDIX I

KEY ISSUES CONCERNING THE DEVELOPMENT OF A SECONDARY MARKET FOR AGRICULTURAL REAL ESTATE LOANS

On the basis of our examination of nine legislative proposals introduced in the 100th Congress and our discussions with individuals and officials from both the private sector and government, we believe that several issues merit additional consideration in the secondary market debate. Our observations on the following questions should help highlight the issues involved.[1]

IS FEDERAL GOVERNMENT INVOLVEMENT NEEDED TO DEVELOP A LARGE NATIONAL-SCOPE SECONDARY MARKET FOR FARM REAL ESTATE LOANS?

Given the historical experience with farm real estate lending, it is unlikely that a large national-scope secondary market for farm real estate loans can be established without federal government involvement. Historically, the federal government has encouraged FCS' role in providing farm real estate loans on reasonable terms because it had determined that such credit was not adequately provided through other lenders. FCS' "agency status" has historically enabled it to obtain a stable source of funds from the capital markets to make long-term farm real estate loans. Wall Street investment house representatives told us that a large secondary market for farm real estate loans could not exist without some degree of government involvement. Given the current financial stress in the farm sector--combined with the economic, weather, geographic, and political environments normally facing the sector--potential risks faced by investors are great.

The private sector has not, of its own accord, developed a large national-scope farm real estate secondary market. The legislative proposals all provide some degree of government involvement to, at a minimum, get such a market off the ground. The major consideration in this area is to what extent federal backing is needed to stimulate or sustain secondary market development. Will the federal government have to be involved in the short or long term to ensure the long-term existence of such a secondary market? Will the federal government have to provide some level of credit enhancement, such as a guarantee or insurance, or would a federal charter be adequate?

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[1]This appendix was developed from information contained in section 3 of our report entitled Farm Finance: Secondary Markets for Agricultural Real Estate Loans (GAO/RCED-87-149BR, July 17, 1987).

Direct federal involvement in the secondary market for home mortgages was critical to the development of that market and still plays a major role today. In the early years federal insurance and guarantees of mortgages and mortgage-backed securities helped accelerate secondary market development. Today, a significant amount of the home secondary market activity is supported by a federally-owned organization--Ginnie Mae--and two other federally chartered organizations--Fannie Mae and Freddie Mac. The federal government does not guarantee or insure Fannie Mae's or Freddie Mac's securities, but the organizations have "agency status" and investors assume the government stands behind their securities. The three agencies accounted for about 79 percent of all mortgage-backed securities issued in 1986. Fannie Mae and Freddie Mac accounted for about 49 percent.

Like the home mortgage market, a federally chartered agency (the FCS) supports the lion's share of farm real estate lending today. If the home mortgage secondary market offers any answers as to the need for government involvement to establish a large secondary market for agricultural real estate loans, the answer is probably yes.

WHAT IMPACT WOULD A LARGE NATIONAL-SCOPE SECONDARY MARKET FOR FARM REAL ESTATE LOANS HAVE ON FCS AND OTHER LENDERS?

The Congress is currently concerned about the health of FCS because it has lost billions of dollars in the last few years and is expected to need federal assistance in the future. The Congress is also concerned about the health of commercial banks that serve agriculture because they have been failing at unusually high rates during the same period. We believe that a secondary market is not a short-term solution to the current financial stress in the agricultural sector, but it does have major long-term implications.

Development of a national secondary market for agricultural real estate loans could strengthen, weaken, or leave unchanged the fates of FCS and other lenders to agriculture. However, the current legislative proposals do not provide enough information to allow a complete understanding of how farmers, lenders, or the government would be potentially affected.

Because of its access to a stable source of credit through the capital markets that other lenders could not match, FCS has dominated farm mortgage lending. Commercial banks, generally, have obtained competitively priced, short-term funds from customer deposits, which has allowed them to maintain a substantial market share for short-term agricultural loans. However, because these

funds are short-term deposits, large percentages of them cannot prudently be committed to long-term fixed-rate loans. Commercial banks and other lenders see the ability to convert long-term mortgage loans to short-term assets (through mortgage loan sales) as positive.

If commercial banks could, without restriction, access the same source of funds at the same cost as FCS, they could potentially increase their market share of total farm lending. Conversely, FCS could potentially lose market share and, all other things being equal, lose a proportionate amount of interest income.

However, the potential impact of a secondary market on FCS and other lenders could be better understood if we knew what organization would operate the market, what fees would be charged, what loan volume might be expected, and what restrictions would be placed on participation. If total farm lending increased substantially and FCS operated a secondary market that all lenders could access without restriction and for which it charged fees to lenders, including the FCS, to provide credit enhancement, it might improve its financial position, even if it lost market share as a primary lender.

On the other hand, if a secondary market for farm real estate loans were to be controlled by any particular lender group, that group could use its control to improve its fee income or market share at the expense of other lenders. In addition, entry to the market could be restricted by qualifying lender and loan criteria. For example, if only lenders with an asset size of $40 million or more would be able to participate, most "agricultural banks," as defined by the Federal Reserve Board, would be precluded from participating. As of December 31, 1986, the average asset size of agricultural banks was about $33 million.

Some commercial agricultural lenders are already concerned about FCS' market share because of the recent changes FCS made in response to the need to be more efficient and minimize operating losses, coupled with its favored access to the capital markets. Prior to the early 1980's, FCS' organizational structure was decentralized down to the local level, with separate locations and management for production credit and real estate credit activities. The commercial banking sector's concern about losing market share flows from reorganizations of FCS at the local level that have taken place since the early 1980's. For example, FCS production lending and real estate lending facilities have consolidated in some areas and colocated in others. The commercial banking sector sees the convenience of "one-stop banking" at FCS, for both production and real estate loans, as a catalyst that could

eventually shift market share of short-term loans from commercial banks to FCS.

SHOULD FCS BE GIVEN POWERS TO OPERATE AS THE SECONDARY MARKET FOR ALL LENDERS?

Arguments for making FCS the secondary market for farm real estate loans are that FCS already performs some secondary market functions, operates in all states, and needs an infusion of capital. It provides liquidity and attracts a wide range of investors; insulates its borrowers against the effects of cyclical flows of funds; enhances regional flows of funds to farmers; and reduces regional differences in interest rates by allowing money to flow to areas of higher interest rates, thereby exerting downward pressure on those rates. FCS has been able to perform these functions largely because of its "agency status" that has traditionally enabled it to access the capital markets routinely for funds. In addition, its charter has permitted it to operate as a national lending agency enabling it to perform the cross-region functions normally attributed to secondary markets.

On the other hand, arguments can be made against FCS being the secondary market. With the changing face of agricultural lending, if the market is not structured in such a way as to allow agricultural lenders, other than FCS, equal access to the capital markets for farm real estate lending, the agricultural credit delivery network as a whole may become too vulnerable to financial stress. Commercial "agricultural banks" may become less able to compete with FCS.

Furthermore, the implications for managing the government's risk exposure to the national agricultural credit portfolio may be unacceptable if one lender--FCS--increases its market share of farm lending. A GAO report entitled Financial Condition of American Agriculture (GAO/RCED-86-09; Oct. 10, 1985) pointed out that farm lenders with loan portfolios more concentrated in agricultural lending were more vulnerable to financial stress in the sector. One solution to this problem may be to develop short-range and long-range plans for agricultural lending that would encourage as many lenders as possible to compete for farm lending, spreading the risk of lending to one sector, as much as possible, throughout the lender and investor community. This strategy could possibly incorporate a plan for FCS to operate the secondary market, thereby deriving more of its future income from secondary market activities rather than from primary lending.

COULD A NEW SECONDARY MARKET ENTITY COEXIST WITH THE FCS?

FCS' favored status in the capital markets raises questions as to whether a new secondary market entity could also compete as well for funds. The issue most related to this question is whether the new entity could attract funds at an interest rate that would allow lenders to make loans at competitive rates.

A related question is how well the investment community would accept another agricultural lending entity, especially when the agricultural sector is still experiencing financial stress and FCS is losing billions of dollars. Wall Street brokerage house representatives told us that if a new secondary market were to be established, it would require at least the same level of government backing perceived by investors for FCS and possibly more to initially establish the market.

WHAT LOANS SHOULD BE ELIGIBLE TO BE SOLD IN THE SECONDARY MARKET?

Probably the most important issue to determining the potential impacts of a secondary market on farmers, lenders, and the government is underwriting criteria that embody specific loan criteria. This single element can determine such factors as market volume; expected loss experience; likely costs to risk bearers, such as investors and credit enhancers; and social benefits to the farm community. For example, underwriting criteria that allowed virtually all farm loans to be sold in the secondary market would result in a high expected loss experience and high risk to investors and others who have provided credit enhancements.

Another component of this eligibility question is whether land-based agricultural loans can be adequately standardized to be included in a national-scope secondary market. While it is possible to develop a standardized loan application that will go a long way to understanding risks associated with the farm sector and individual farm operations, it will likely be more difficult to develop large pools of loans with substantially homogeneous characteristics. For example, Midwest grain farms have much different cash-flow characteristics than West-coast ranches with tree crops and vineyards.

UNDERWRITING STANDARDS AND RISKS IN SECONDARY MARKETS: A PRIMER

This appendix provides answers to key questions on underwriting standards and risks in secondary markets. Those questions are (1) What are mortgage underwriting standards?, (2) How are risks borne in a secondary mortgage market?, and (3) What risk implications exist in current secondary market securities?[1]

WHAT ARE UNDERWRITING STANDARDS?

Underwriting standards are criteria, or guidelines, used to limit the type and amount of risk of loss permitted in a financial portfolio and establish methods to insure against those risks. For example, if an automobile insurance company insures only drivers with accident-free driving records, the prices--or premiums--the company charges to insure against expected losses should be lower than if the company insures motorists without accident-free driving records. The underwriting guidelines in this case would address the driving records of those who potentially could be insured.

Underwriting is the process of (1) identifying potential risks of loss associated with financial instruments, such as insurance policies, and (2) either assessing the expected costs of covering those risks or providing the essential information that would allow others to make such a determination. Underwriting is an integral part of business and financial transactions that occur daily throughout the private and public sectors of the economy and involve the transfer and pricing of risk. The underwriting process is used when a business sells many types of financial instruments, including insurance policies, stocks, bonds, and loans.

Banks use the underwriting process and underwriting standards to make individual loans that they may hold in their portfolio or later sell in a secondary market. These standards address factors, such as past credit history, current and projected income, and expenses, that reflect on the potential borrower's willingness and ability to pay. This information is used to make a lending decision. When a bank decides to make a loan, it sets loan terms, including an interest rate, collateral values, and other conditions consistent with the risks involved in the loan. An individual with

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[1]This appendix was developed from information contained in section 1 of our report entitled Federal Agricultural Mortgage Corporation: Underwriting Standards Issues Facing the New Secondary Market (GAO/RCED-89-106BR, May 5, 1989).

a good credit rating and sufficient collateral is likely to receive more favorable terms--including a lower interest rate--than a borrower with a delinquent payment history or limited financial resources. Some risks, such as the credit risk and character of borrower, can be controlled through use of underwriting standards; other risks, such as the changing economic environment, cannot be controlled by underwriting standards and are handled through pricing and use of credit enhancements like insurance, reserves, or guarantees.

Underwriting in the Secondary Mortgage Markets

The investment market is usually defined in terms of primary and secondary markets. A primary market exists at the point that an original debt or ownership interest is created; for example, when a company sells a new issue of stock. In its simplest form, a secondary market transaction occurs when a loan is sold by the originating lender or a stock is resold by an investor. Thus, essentially a secondary market involves the buying and selling of existing rather than new products. Secondary markets exist for several types of financial assets, such as mortgages, car loans, credit card receivables, and manufacturers' notes receivable. A secondary market transaction is made when a bank sells existing loans to other banks or investors or when a number of these loans are packaged into pools and resold to investors through the use of securities backed by these loans or mortgage-backed securities. Risks inherent in the individual loans and the specific pools must be identified so that investors have confidence about their ultimate returns. Our report entitled Farm Finance: Secondary Markets for Agricultural Real Estate Loans (GAO/RCED-87-149BR) dated July 17, 1987, provides further information on the secondary mortgage market concept.

In secondary markets for residential and commercial mortgages, competent underwriting helps protect those who are taking the risks involved in guaranteeing payments of mortgage-backed securities. In these markets lenders can convert their long-term assets--which in this situation would be long-term mortgages--into short-term assets by selling the loans to secondary market entities. These entities buy loans that meet their criteria, which usually ensure that the loans are readily saleable. The secondary market entities package the loans or pool them together with other loans, using established underwriting standards, and in turn transfer or spread their risks by issuing securities backed by the underlying loans to the investing public. As a result, investors can invest their funds in securities that can be easily converted into cash--having liquidity--and are marketable, without incurring the costs of evaluating the risk associated with individual loans. To encourage investors to purchase such securities and to increase their

confidence in the securities, poolers can guarantee or insure timely principal and interest payments, for a price, through the use of private insurers. Governmental guarantors also, at times, bear the risks of loss associated with the securities.

The Federal Home Loan Mortgage Corporation (Freddie Mac), Federal National Mortgage Association (Fannie Mae), and Government National Mortgage Association (Ginnie Mae) were created for the purpose of sponsoring secondary markets. Freddie Mac and Fannie Mae are known as government-sponsored enterprises,[2] and Ginnie Mae is a federal agency. These organizations operate with mortgage-backed securities having varying types of guarantees. Some guarantees are provided by the federal government; others are provided by the government-sponsored agency. Government agencies such as the Federal Housing Administration (FHA) and Veterans Administration (VA) also provide guarantees on individual mortgages, which lenders sell to poolers.

Underwriting standards in current government-sponsored secondary markets are found in legislation and in the agencies' implementing guidelines. Standards that are found in legislation may be stated in broad or specific terms. Standards found in implementing guidelines interpret, clarify, and expand upon legislated standards or are developed by the responsible agency to address areas where legislation is silent and where there is a need for guidelines. Legislation that provides specific standards limits the flexibility an agency has in carrying out certain provisions of the legislation but gives the Congress more control over the operation of the market.

Underwriting standards address both pools of loans that are used to back securities and individual loans that make up the pools. Some standards affect both pools and individual loans; others affect one or the other. For example, the size limitations of a pool would affect only the pool while the size limitations of individual loans could affect both the pool and the individual loan. In addition, standards applying to property appraisals generally affect only individual loans.

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[2]A government-sponsored enterprise is an instrumentality established by the government and accorded favored regulatory treatment to increase access to the capital market for specific economic sectors--including agriculture--thought to be inadequately served by fully private lenders.

HOW ARE RISKS BORNE IN A SECONDARY MORTGAGE MARKET?

Existing secondary markets for residential mortgages, commercial loans, and certain agricultural loans are structured to manage risk by transferring risks to certain market participants. Risk bearers involved in secondary mortgage market transactions include (1) originators of loans (lenders), (2) poolers who purchase loans from the lenders and issue securities, (3) insurers of loans that are ultimately included in a pool, (4) guarantors of loan-backed securities issued by poolers, and (5) investors in the securities. Risks fall into two broad categories--risks related to changes in the general economy, which affect all securities, and risks that are unique or specific to individual securities.

Who Are the Risk Bearers?

All of the risk bearers--loan originators, poolers, insurers, guarantors, and investors--differ in the role they play in the secondary market for residential loans; but all make it possible for the existence of a large, active investment market for such loans. Most of the largest secondary mortgage markets are sponsored by the federal government. Organizations most often associated with the secondary residential mortgage market are Ginnie Mae, Fannie Mae, and Freddie Mac. All three serve as guarantors; Fannie Mae and Freddie Mac also serve as poolers and investors in loans that have not been pooled. Other organizations, such as large banks, mortgage bankers, and state and local governments, can serve alternately as all types of risk bearers--loan originators, poolers, insurers, guarantors, and investors--in a secondary mortgage market.

Ginnie Mae, Fannie Mae, and Freddie Mac--as guarantors--were created by federal law and thus have "agency status," and the financial community perceives that their securities are backed by the government.[3] In reality, only Ginnie Mae is a federal agency, and its debt is backed by the full faith and credit of the federal government. However, Fannie Mae and Freddie Mac, although created by statutory charter, are private organizations without explicit federal government guarantees. These organizations do share a common characteristic of encouraging investors to buy mortgages or securities representing a pool of mortgages by assuming risks that would otherwise be borne by the original lender or the investor. This is done by providing a guarantee to investors that the principal and interest derived from the underlying mortgage payments will be paid in case of borrower default.

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[3]This perceived government backing has not been tested for Fannie Mae and Freddie Mac.

What Are the Risks?

Potential risks in existing secondary markets include the general market risks of interest rate changes and inflation and the cash-flow risks inherent in defaults, prepayments, reinvestments, refinancing, and liquidity--the ability to quickly convert securities into cash. Some of these risks are less manageable than others, but existing secondary markets have used risk management to shift risk from their portfolios to other market participants. Market participants must use available information to identify and analyze these risks through market mechanisms and arrive at a price on securities that will compensate them for their perceived risk. Generally referred to as risk pricing, this process is used by participants to decide what types of securities would be better to meet the risk and investment return preferences of investors. In addition to risk pricing, the cost of conducting the buying and selling transactions must be included in determining security types.

To quantify and compare these risks and potential returns on alternative investments available in the market place, participants must have access to adequate market information. Investors form expectations about risks and returns on the basis of the information that is available at the time investment decisions are made. Market information addresses such factors as the history of loan defaults (when a borrower fails to repay the loan), delinquencies (when a borrower fails to make loan payments on time in accordance with established repayment schedules but does not default), bankruptcies, interest rate changes, market conditions, and early loan payments.

The greater the amount of relevant and reliable information available to investors at the time they form their risk and return expectations, the better the market is in discovering, pricing, and dealing with risks. For example, forecasts of market performance can be wrong, especially where little information exists, so the risk taker needs to analyze available information for developing different scenarios and evaluating possible default rates, interest rate changes, and other factors. The risk taker uses these scenarios to determine how to handle these risks, realizing that risks are not the same across the nation even for the same market or for similar markets and that methods for managing risks, such as portfolio diversification, do not necessarily eliminate risks but strive to make overall risks less volatile.

Certain risk factors affect the amount, timing, and uncertainty of cash flows received by investors but are difficult to measure. In agricultural loans, for example, federal farm

subsidy payments are subject to change, thus altering cash flow and affecting returns on agricultural investments. Further, federal farm credit programs that provide loan guarantees and interest rate subsidies can change, affecting the amount of the guarantees or subsidies and exposing investors to additional risks. Weather conditions, such as the 1988 drought, can also have adverse impacts on agriculture and change the cash-flow position of farmers in various regions of the country.

For most existing secondary market securities backed by pools of loans, information needed to evaluate risk for specific securities is available to some degree. Risk can be divided into general market risk and cash-flow risk. General market risk, of interest rate changes and inflation, affects returns to investors, is related to the overall movements in the general economy, and is usually more difficult to manage than cash-flow risk. Cash-flow risk stems from repayments of loan principal by borrowers. Cash-flow risk is specific or unique to a particular security issue and is caused by actions of the lender, borrower, pooler, or others, altering the cash flow to the investor.

General Market Risks

Major risks facing secondary market poolers and investors are changing market interest rates, which increase or decrease the market price of their securities, and inflation, which affects all securities by reducing the purchasing power of the income returns and invested dollars. Measuring these potential risks and the effects they could have on market participants' behavior is difficult because of the uncertainty in making, analyzing, and interpreting forecasts of future interest rates and inflation.

Interest rate risk can have a tremendous effect on the market value of securities. For example, when market interest rates increase, the value of lower-interest-rate securities held by investors, decreases. Because potential investors have the option to buy the new higher-interest-rate securities, all other things being equal, they would purchase the older securities from the current holders only if the market price of the securities were discounted to provide the same yield as the new securities. If, for some reason, investors holding the lower-interest-rate securities decided to sell in a higher-interest-rate environment, they would experience a loss on their investments.

Interest rate risks are sometimes managed by using a defense against financial loss called "hedging." Hedging makes it possible to reduce risks of volatile rates to security holders by negotiating set prices for the future regardless of whether the market rates increase, stay constant, or decrease. Security

holders, for instance, might enter into a contract to sell their securities at a later date for a set price. Whether the interest rate increases or decreases, they receive the same price at the time of the sale. The security holders have hedged against fluctuating interest rates and price declines.

Inflation risk is highly dependent on changes in the macroeconomic environment and other financial factors. Inflation refers to a rising level of prices as measured by a general price index. Inflation reduces the purchasing power of the dollar, and as a result, lenders tend to demand higher interest rates to compensate them for the reduction. For a particular security, risks of inflation, as well as changes in interest rates, can be managed through the use of innovative financial instruments, such as adjustable interest rate loans.

Cash-Flow Risks

Cash flow risks for an investor or a pooler in a secondary mortgage market involve the availability of funds for poolers to make payments to investors when due and for poolers and investors to obtain funds by liquidating the security when cash is needed. Availability depends primarily on whether (1) borrowers default or become delinquent on payments or pay the loans off early, (2) poolers reinvest excess cash flow wisely or are able to refinance when a shortfall occurs, and (3) the securities are liquid enough to be converted into cash. To help manage all these risks, a pooler would issue securities whereby mortgage payments are passed through to investors. However, investors might want different types of securities to avoid the same risks or may demand to be compensated for these risks by requiring a higher interest rate.

Default risk occurs when, and if, issuers of secondary market asset-backed securities fail to collect from loan originators enough mortgage payments to pay investors the periodic interest payments or to repay investors the principal amount at the time specified in the contract because borrowers default or become delinquent on the underlying mortgages. For example, borrowers with variable interest rate mortgages may not be able to make payments when interest rates increase. To protect the investors, some securities, such as bonds, contain provisions that place strict obligations on the issuer who generally holds the mortgages. Government-sponsored markets have additional provisions that preclude a loan originator who defaults because of fraud from continued participation in the market.

In existing secondary markets, certain mechanisms--called credit enhancements--have been developed for transferring risks to other parties to help guard against the default risk being passed

on to investors. Issuers of securities can reduce or eliminate investors' exposure to these risks by using various methods of guaranteeing or insuring the timely payment of principal and interest, such as government guarantees, private insurance, or special reserves that can be drawn on to make such payments. For example, as far as investors are concerned, default and delinquency risk does not exist for U.S. Treasury securities. Securities of U.S. government-sponsored agencies, i.e., Fannie Mae, Freddie Mac, and Ginnie Mae are generally considered to have virtually no default or delinquency risk largely because of actual or implied government guarantees to pay security holders and because investors believe that the government would act to prevent these organizations from defaulting.

Prepayment risk is manifested when borrowers make early principal payments on mortgages or pay the entire principal amount before loan maturity. For example, as interest rates decrease, a borrower with a fixed interest rate is more likely to pay off the mortgage--thereby removing it from the pool of loans--more quickly so it can be refinanced at a lower rate. Conversely, when interest rates increase, a borrower who has a variable-rate loan and expects that interest rates will continue to rise over an extended period may pay off the loan and obtain a fixed-rate loan to lock in an interest rate. Under these scenarios, all principal is repaid but future interest payments are forfeited. This creates reinvestment decisions on how to obtain the best returns in a "down" interest rate market. (See the discussion under "Reinvestment risk" below.)

Prepayments expose investors in some types of secondary mortgage market securities to the risk that they will receive less return on their investment than anticipated. These prepayments mean that the principal amount of a loan is invested for a shorter period than investors expected and, as a result, can expose investors to the possibility that they may not be able to reinvest funds received as prepayments to receive the same or greater return.

Investors can avoid prepayment risk by buying securities, such as bonds, that do not permit prepayments and that promise to pay specified amounts of principal and interest periodically over the life of the security. Where permissible, institutions may charge fees or higher interest rates for loans that are prepaid or subject to prepayment conditions to cover the added risks involved. For example, some commercial real estate mortgages include terms that allow lenders to impose a penalty charge on borrowers who pay off their loans during the first few years of the mortgage. In addition, some lenders charge higher interest rates on loans that

allow prepayments, as a pricing mechanism to recognize the risk involved in that kind of loan.

Reinvestment risk is caused by poolers having idle funds resulting from a difference in amount and/or timing of (1) income received by the pooler from mortgage payments and (2) amounts paid to investors. For example, a pooler receives annual payments from borrowers and splits these into quarterly payments to investors; the pooler invests all funds received that are not paid to investors. Both poolers and investors in loan-backed securities are subject to the risk of poolers having to invest cash receipts (interest income and principal payments, including prepayments) at lower than anticipated interest rates because of a general decline in market rates. As a result, the actual return on the investment could be less than the expected return. Investors can reduce potential reinvestment risks by purchasing bonds that pay a fixed amount at maturity.

Refinancing risk occurs when a pooler has a shortage of funds because of a timing difference between cash inflows from loans and cash outflows to investors in securities backed by the loans. This timing difference may cause the pooler to borrow funds to avoid a shortfall in making scheduled payments to investors. For example, defaults on underlying loans for a bond issue may cause a shortfall in cash flows going into the pool. It may take some time before foreclosure and recovery can be accomplished. In the interim, the pooler may have to obtain additional carryover financing--or refinance--to make up cash deficiencies in meeting semiannual interest payments on the outstanding securities until maturity. Investors do not experience refinancing risk in secondary markets, and poolers can minimize risk by using security design structures that pass payments directly to investors.

Liquidity risk in a secondary market relates to the ability to convert the asset-backed securities into cash quickly. It is a risk investors take that they will not be able to readily dispose of their investments through the subsequent sale of the security at a price that will let them recoup their original investment at any time they choose. In general, the more uncertainty that exists, the thinner the market and the greater the liquidity risk. For example, a U.S. government security has little or no liquidity risk because such securities are widely traded, partly because of the investors' faith that the government will stand behind it, whereas the stock of a small company traded on the open market may have substantial liquidity risk. Liquidity risk can be lessened by purchasing low-risk securities, such as Treasury securities, that are actively traded in a secondary market characterized by a large number of buyers and sellers.

WHAT RISK IMPLICATIONS EXIST IN CURRENT SECONDARY MARKET SECURITIES?

The success of the various secondary markets in attracting a wide range of investors was made possible in part by their ability to offer a variety of asset-backed securities--including pass-through securities, mortgage-backed bonds, mortgage pay-through bonds, collateralized mortgage obligations (CMO), and real estate mortgage investment conduits (REMIC)--designed to provide the risk protection and returns sought by investors. These securities, described more fully below, have different risk implications for the market participants, ranging from almost no risks to high risks. The residential mortgage secondary markets have led the way in the area of security design. Other secondary markets offer securities modeled after those originally introduced by Ginnie Mae, Fannie Mae, and Freddie Mac. Investors in securities backed by mortgages include commercial banks; savings and loan associations; mutual savings banks; state and local government agencies; pension funds; and private citizens, either individually or through mutual funds. These securities allow investors to invest in mortgage assets without having to become involved in the costly administrative details.

Pass-Through Securities

With a pass-through security, the borrowers' mortgage payments of interest and principal, minus fees for servicing and other charges, are passed through to the holders. Thus, the holders of a pass-through security have an ownership interest in the security's underlying mortgages.

Since the security holders own the mortgages, they are subject to risks of interest rate and inflation, default, prepayment, reinvestment, and liquidity. However, the major risk associated with residential mortgage-backed pass-through securities is prepayment caused when borrowers refinance mortgages as market interest rates decline. This often can result in a reduction in total return to the security holders. Frequently, poolers bear the risk of default by guaranteeing or insuring, for a fee, the timely payment of principal and interest to investors. The most common pass-through security is the Ginnie Mae, which is issued by private entities and backed by residential mortgages insured by FHA and VA. Ginnie Mae offers, through the full faith and credit of the federal government, guarantees for the timely payment of scheduled monthly principal and eventual payment of interest to investors.

Mortgage pass-through securities are also issued directly by private originators or poolers. These pass-throughs are not insured or guaranteed by any government agency but are supported

only by the quality of the underlying loans and any credit enhancement mechanism used to transfer the risk of the pool to another party. Two types of credit enhancements traditionally have been used to manage pass-through risks, namely mortgage pool insurance, or guarantees provided by private insurance companies, and letters of credit provided by commercial banks.

In 1986, private sector entities began issuing a third type of credit enhancement, senior/subordinated pass-through securities. In such securities, payments of principal and interest are passed through to investors on a prioritized basis: servicing and trustee fees are paid first; senior security holders are paid second; a reserve fund is established and maintained at a certain balance third; and finally, subordinated security holders are paid from any remaining funds. The size of the subordinated class of securities is established according to how much protection against loss the investor or issuer desires--the larger the subordinated class, the more protection--and what security rating is sought--the better the rating, the more protection is needed.

The senior pass-throughs are usually sold to investors after being rated by a nationally recognized agency, such as Standard and Poor's Corporation or Moody's Investors Service. The rating on the senior security is supported by the subordinated security in that no payments are made to the subordinated security holders until after the senior security holders have been paid. These subordinated securities may be designed to meet the needs of the participants and may be sold to investors or retained by the issuer. In some cases, the subordinated securities have been sold to investors at a substantially higher yield compared to the senior class of securities because of the higher risk associated with their expected cash flows. A July 1988 study by Goldman, Sachs and Company indicates that, through June 1988, about 60 percent of conventional pass-throughs had this type of credit enhancement.

Mortgage-Backed Bonds

Mortgage-backed bonds are secured, or collateralized, by home mortgage loans owned by the bond issuer who is usually a private-sector mortgage originator, such as a savings and loan association, a savings bank, or a mortgage banker. These securities have a maturity date and a stated principal and rate of interest. They promise to pay investors interest semiannually and to repay the principal amount at maturity.

Prepayment, reinvestment, and refinancing risks are borne by the issuer of mortgage-backed bonds since the bond contract provides for the issuer to make scheduled interest and principal payments without regard to the timing or amount of payments the

issuer receives from the pooled mortgages. Default risk for mortgage-backed bonds is minimized since such bonds are usually over-collateralized, meaning that the collateral must continue to have a market value exceeding the face value of the outstanding bonds.

Mortgage Pay-Through Bonds

Mortgage pay-through bonds are collateralized by home mortgage loans owned by the bond issuer who is usually the mortgage originator, such as a savings and loan association, a savings bank, or a mortgage banker. These bonds are like pass-through securities in that they link the cash flow from the collateral to the cash flow on the bonds. Payment frequencies of the borrower on the mortgage and the issuer on the bonds may differ; however, the issuer assumes the risk of making up any shortfall. Principal payments on the bonds fluctuate depending on prepayments, defaults, and delinquent payments.

The issuer assumes any reinvestment risks due to prepayments. However, in the event of default, who assumes the risk depends on the liquidation value of the collateral and the types of guarantees and insurance provided in the contract between the issuer and the bond holder.

Collateralized Mortgage Obligations

CMOs are bonds created from the cash flow of underlying pools of conventional mortgages. The principal and interest receipts from the mortgages have no direct relationship to payments to the bond holders. Each pool of mortgages that backs the bonds is divided into a series of bonds, commonly referred to as "tranches," that have their own maturity dates and fixed interest rates. Cash flow from the mortgages is used by the issuer to make payments to holders of the various tranches. These payments are prioritized: first, interest payments are made to all tranches, and then principal payments are made to the tranche that has the earliest maturity date, to the tranche with the next earliest maturity date, and so on. After interest payments have been made, all available cash goes to repay principal on the "fastest-pay" tranche. Following retirement of the first tranche, the next tranche in the sequence becomes the exclusive recipient of principal payments until this tranche is retired. This sequential process continues until the last tranche of bonds is retired. The most common type of CMO has been a four-tranche CMO, although CMOs have been structured with over a dozen tranches. The average life of individual tranches may overlap or there may be gaps of time between the tranches. The average maturity of a four-tranche CMO might be as follows: first-tranche bonds, 1 to 3 years; second-

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tranche bonds, 3 to 7 years; third-tranche bonds, 5 to 10 years; and fourth-tranche bonds, 15 to 20 years.

The earlier tranches have short or intermediate final maturities and attract investors seeking low exposure to interest rate risk. Since the shorter tranches must be retired before the longer tranches receive principal payments, the longer tranches have a limited amount of prepayment and reinvestment risk although they are exposed to risks of default, inflation, and liquidity. Investors who desire less prepayment risk and less reinvestment risk prefer the longer tranche of a CMO over a pass-through security that has no prepayment risk protection.

Real Estate Mortgage Investment Conduits

The Tax Reform Act of 1986 permitted a new tax-free entity called a REMIC that can hold mortgages secured by any type of real estate and issue multiple classes of mortgage-backed securities to investors. (Securities, issued by these entities, also have come to be known as REMICs.) Among other things, the law grants flexibility to entities who issue mortgage-backed securities and elect to be treated as a REMIC for tax purposes by allowing them to use all the above mortgage-backed security designs that are tailored to meet specific investor needs without being taxed as a separate taxable entity.[4]

Generally, an entity qualifies as a REMIC if substantially all of its assets consist of qualified mortgages. A REMIC offers advantages to issuers of mortgage-backed securities: (1) a REMIC is treated as a partnership for tax purposes, meaning that it is not subject to federal income tax provided it meets all the requirements of the law, and (2) REMICs can structure mortgage-backed securities to allow the pooler to consider the issuance either as a pass-through or as a CMO. Since a REMIC is capable of issuing multiple-classes of mortgage-backed securities that resemble CMOs, risks of interest rate, inflation, default, prepayment, reinvestment, and liquidity apply much the same as with CMOs, depending on the length of maturities of the various classes.

In secondary mortgage markets, tax considerations are important because decisions about the type of mortgage-backed securities sold to investors is affected by the economic consequences of existing tax laws. Securities issued by REMICs are one of the newest forms of mortgage-backed securities in secondary

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[4] For a discussion of REMICs and their operations, see our report entitled Housing Finance: Agency Issuance of Real Estate Mortgage Investment Conduits (GAO/GGD-88-111, Sept. 2, 1988).

mortgage markets, and the volume of these securities has grown to an annual issuance of over $300 billion. Government-sponsored residential mortgage secondary markets--Fannie Mae and Freddie Mac--have issued most of the REMICs to date.

KEY UNDERWRITING STANDARDS ISSUES FACING FARMER MAC

On the basis of our review of underwriting standards provisions for Farmer Mac in the Agricultural Credit Act of 1987, underwriting standards and practices used in various existing secondary markets, and our discussions with individuals and officials from both the private sector and the government, we believe that the following are key issues relating to overall risk management that merit consideration during the legislative review process for Farmer Mac underwriting standards.[1]

WHAT ARE THE IMPLICATIONS OF THE GEOGRAPHICAL DIVERSITY REQUIREMENTS IN THE ACT?

The act requires each loan pool to consist of loans that are secured by agricultural real estate that is widely distributed geographically. The act does not define what is meant by "widely distributed geographically;" however, this concept could have a major effect on market operation and performance.

Defining geographic diversity will require determining levels of risk Farmer Mac should accept in providing guarantees for pools of loans from different areas of the country. For example, pools of loans concentrated in one area or region whose economy is not diversified are more likely to fluctuate with that area's economic conditions, thereby making the pool more risky. Some areas of the United States have a higher degree of risk than others because of such factors as less crop diversity, more unpredictable weather conditions, poorer soil, fewer transportation networks, and the area's reliance on export versus domestic markets. Secondary markets, in general, have the ability to reduce overall risk by spreading risks of individual loans over a pool of loans. One way to spread those risks is to include in the pool loans from various parts of the United States so that the pool does not consist of loans only from the same area/region. Areas, such as the West Coast--with diverse agricultural commodities and a high degree of domestic and export commodity mix--could conceivably be packaged into pools that would have less overall risk than a pool of loans from the Midwest--with a reliance on export markets that may rise as they did in the 1970s or slump as they did in the early 1980s. Thus, packaging Midwest and West Coast loans into one pool may improve the risk performance of a purely midwestern pool of loans.

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[1]This appendix was developed from information contained in section 4 of our report entitled Federal Agricultural Mortgage Corporation: Underwriting Standards Issues Facing the New Secondary Market (GAO/RCED-89-106BR, May 5, 1989).

Defining what is meant by loans that are secured by agricultural real estate that is widely distributed geographically may also require determining the size that financial institutions should be to be poolers of Farmer Mac-guaranteed loans. A definition of "widely distributed" may stipulate any of several pool constructions: a national portfolio consisting of loans from all regions of the United States; a regional portfolio of loans from one region (such as the Southwest, Midwest, or West Coast); a portfolio from one or two states; or any combination of these or other interpretations. The wider the area encompassed in this definition, the more difficult it will be for smaller financial entities to be primary poolers since they would need to have access to a regional or nationwide network to purchase loans outside their areas. However, under this scenario, smaller organizations could conceivably become subpoolers or regional poolers that package loans to be sold to the major pooler and included in large pools receiving a Farmer Mac guarantee.

The demographic characteristics of stockholders that purchased Farmer Mac stock indicate that the market structure may be able to accommodate a national diversification strategy and, at the same time, meet legislative requirements that smaller institutions be included in the market so that liquidity in the loan market can be achieved at these institutions. Preliminary analysis indicates that both small and large institutions--including those with assets of $25 million or less and those with over $160 billion--operating in all states have purchased Farmer Mac stock and that they are predominantly from the Midwest. In addition, most of those that have purchased enough stock to be poolers are generally large enough to be regional or national poolers.

In December 1988, the Farmer Mac Interim Board completed its sale of common stock for capitalization purposes and for purposes of determining which stockholders would qualify to be poolers and which ones could be only loan originators. The stock was divided into two classes--A and B--with the same par value per share. Class A stock was to be held only by non-FCS entities that are insurance companies, banks, or other financial institutions. Class B stock was to be held only by FCS institutions. All potential stockholders were required to purchase at least 250 shares of stock to participate in the market. Potential class A stock purchasers had to purchase designated amounts of stock based on their asset size while potential class B stock purchasers only had to purchase 250 shares regardless of size. Potential class A stockholders were required to purchase stock based on the following schedule: 250 shares for institutions with less than $50 million in assets; 500 shares for institutions with between $50 million and $100 million in assets; 1,250 shares for institutions with between $100 million

to $500 million in assets; and 5,000 shares for institutions with over $500 million in assets. Additionally, both class A or class B stock purchasers who desired to become poolers had to purchase at least 12,500 shares.

Preliminary analysis of class A stock purchase transactions indicates that 1,614 institutions purchased stock. Information on class B stock was not available for analysis. Of those that purchased class A stock, 22 purchased enough to qualify, contingent on meeting Farmer Mac certification standards, as poolers--10 of which are commercial banking institutions, 3 are investment banks, 6 are insurance companies, 2 are trust companies, and 1 is a commodity firm.

According to an analysis performed by the Independent Bankers Association of America, of the 1,614 institutions that purchased class A stock, 1,496 are commercial banking institutions. Current analysis indicates only that the other 118 were not commercial banks. About 74 percent, or 1,100 of the institutions have assets of less than $50 million--574 with assets of $25 million or less, 326 with assets from $25 million to $37.5 million, and 203 with assets from $37.5 million to $50 million. In addition, about 26 percent, or 393 banking institutions with assets over $50 million bought shares: 284 with assets from $50 million to $100 million; 93 with assets from $100 million to $500 million; and 16 with assets over $500 million. Involving the smaller banking institutions in Farmer Mac appears to be consistent with the act's requirement of not discriminating against small lenders and its purpose of providing greater liquidity so that agricultural borrowers might benefit from the new market.

At the time the shares were offered, all 12 Farm Credit Banks and the Central Bank for Cooperatives indicated that they would purchase class B shares. As a result of the Agricultural Credit Act of 1987, the FCS is undergoing reorganization including a mandatory merger of various banks comprising the system. Although FCS officials had made no decisions on who would be poolers or originators, they told us that they are currently working on a plan to develop a FCS-wide certified pooler with all FCS institutions as potential originators of loans.

WHAT ARE THE IMPLICATIONS OF AGRICULTURAL COMMODITY DIVERSITY REQUIREMENTS IN THE ACT?

The act states that a pool must consist of agricultural real estate loans representing a wide range of agricultural commodities. The term "wide range" is not defined in the act, yet such a definition could have a major impact on the operation of the market. This issue is closely related to geographical diversity.

Secondary markets can use loan diversity within a pool to help spread risks; however, most residential secondary markets have loan pools that are homogeneous in terms of loan types, for example, 1-to-4 family homes. In the case of Farmer Mac, it may be possible to reduce risk of default of any one pool when a pool includes loans covering a diversity of commodities. If a pool consists of loans backed by agricultural real estate used to produce a diversity of commodities (such as wheat, grapes, cattle, corn, vegetables, and fruit), poor economic performance by any one commodity would tend to have less effect on the overall portfolio than a pool that consisted of only one commodity type and that commodity was performing poorly.

Individual banks and holding companies located in a region that produces primarily one or two types of commodities may find it easier to become poolers of agricultural real estate loans if a "wide range" of commodity diversity is defined to mean commodity diversity within a given region. However, that definition may translate to fewer rather than a larger number of commodities and more potential risks for poolers. On the other hand, national poolers may have less risk--as explained above--and regional poolers would probably be able to buy loans outside their regions to become national poolers.

CAN STATE-OF-THE-ART REAL ESTATE APPRAISALS PROVIDE ENOUGH ASSURANCE IN VERIFYING CASH-FLOW POTENTIAL AND AGRICULTURAL REAL ESTATE VALUES TO ENABLE PRUDENT LOAN-MAKING DECISIONS?

An agricultural real estate loan by nature is more difficult to appraise because of its complexity. It tends to be more similar to a commercial real estate loan--rather than a residential loan--relying on income generated through commodity production to repay the loan. In contrast, residential real estate, even rental property, relies on the current resident's income that can come from diverse sources reflecting a wide variety of professions.

An appraisal of agricultural real estate depends, to a large extent, on cash flow as a key factor in making a reliable estimate of both annual operating income and the fair market value of any commercial enterprise or farm. Income and fair market value estimates are used to determine the debt-carrying ability of the enterprise, thereby providing information to evaluate against certain qualifying financial ratios. The fair market value estimate, which represents the appraised value of the enterprise, is also used in setting maximum loan size by multiplying fair market value by the loan-to-value ratio.

State-of-the-art appraisals are based primarily on residential rather than commercial business appraisal methods and techniques. Differences between housing and agricultural markets bring into question whether these methods and techniques will provide a reliable verification of agricultural real estate values and related cash-flow patterns for loan-making and underwriting purposes. (See app. III of GAO/RCED-89-106BR for a more detailed discussion of appraisals.) Some important distinctions between agriculture and housing credit markets exist:

-- Off-farm income can provide an additional income stream to evaluate in making loans. However, loans for agriculture real estate are based on the expected cash flow generated by commodities the borrower can produce and sell, realizing that production and sales rely heavily on factors--such as changing federal farm subsidies, world market demand, weather conditions, and interest rates--that are largely uncontrollable by the farmer.

-- A residence generally has a relatively stable collateral value that some business enterprises may lack.

-- Farm properties are much less homogeneous than residences, have higher unit prices, are harder to appraise, and may be more difficult to liquidate if the loan defaults.

-- In agriculture, the capacity of the operator, in terms of both financial and business/management skills, has an important determining effect on the value of the collateral.

In recent years, various government reports have questioned the ability of the appraisal industry and financial institutions involved in loan making to ensure that appraisal practices provide a basis for adequate loan-making decisions. According to a 1988 report from the House Committee on Government Operations, faulty and fraudulent appraisals have been associated with a number of failed banks and savings and loan institutions. According to the report, these abusive appraisals are recognized as a serious national problem whose harmful effects are widespread and costly. Additionally, a 1986 report from the House Committee on Government Operations states that standardization in appraiser qualifications is lacking--only 33 percent of the nation's real estate appraisers belong to any highly regarded professional trade association; and these organizations have been unable to successfully discipline their members. Further, in testimony before the House Committee on

Banking, Finance, and Urban Affairs on January 13, 1989,[2] GAO reported that, of the 26 failed savings and loan institutions reviewed, 88 percent had violated federal regulations requiring them to obtain appraisals of loans. Some did not obtain appraisals or obtained appraisals after the loan had been made.

The Congress has taken steps to reduce appraisal fraud, abuse, and inconsistency and to raise the standards of the real estate appraisal profession to a level at which all real estate appraisers will produce the highest quality work for their clients. The Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, proposed legislation in November 1987--the Subcommittee plans to reintroduce the appraisal legislation in the 101st Congress--to establish uniform appraisal standards at the federal level to ensure that any loan or transaction that could ultimately lead to federal government liability and involve appraisals is to have appraisals performed in accordance with uniform standards by certified appraisers. Although not specifically included in the proposal, agricultural standards could be interpreted to come under the purview of the legislation. According to officials of the American Society of Farm Managers and Rural Appraisers, mortgages sold in the new agricultural real estate secondary market should be included in the appraisal guidelines in this proposed legislation. They said that appraisers of agricultural real estate should be certified with additional accreditation and education documenting their abilities as rural real estate appraisers.

Given the billions of dollars of government-sponsored secondary mortgage market securities outstanding and the current savings and loan problems--many directly related to appraisals--the potential liability to the government, as a result, is becoming an increasingly important concern for secondary markets in general. Because Farmer Mac's legislative history indicates that the Congress did not want the government to assume major risks in this market, the "lessons learned" from the savings and loan appraisal problems may help formulate appraisal policy for Farmer Mac.

HOW WOULD THE USE OF LENDER OR POOLER SUBORDINATED PARTICIPATION INTERESTS VERSUS CASH RESERVES AFFECT THE FEDERAL GOVERNMENT'S FINANCIAL RISK ON SECURITIES GUARANTEED BY FARMER MAC?

The act provides that a pooler must establish either a cash reserve or subordinated participation interests of at least 10

2Failed Financial Institutions: Reasons, Costs, Remedies and Unsolved Issues (GAO/T-AFMD-89-1, Jan. 13, 1989).

percent of the outstanding principal of a pool of loans. In the event of a pooler's inability to make principal and interest payments to investors, these funding sources are to be used first to make such payments. The act does not provide a clear definition of subordinated participation interest. In addition, it does not explain how pooler's and lender's cash reserves are to be structured.

The Senate report on the bill, which became the Farmer Mac legislation, states that the subordinated participation interest provision ensures that FCS banks and associations in a weakened financial condition will not be precluded from participating in this market because of an inability to establish a cash reserve. The conference report accompanying the act states that it was the intent of the conferees to provide poolers with flexibility in the design of subordinated participation interests. Although the act specifies a cash reserve of at least 10 percent of the outstanding principal of the pool is to be established, it does not specify that it must be "maintained" at the same level.

The legislative history does not indicate whether the Congress intended to accept more risk by using either a subordinated participation or a cash reserve credit enhancement but does indicate that the Congress did not want to assume major risk exposure from Farmer Mac. The amount of potential government risk that is ultimately realized depends on how the cash reserves and subordinated participation interests are structured.

Current Usage of Cash Reserves

An entity that issues securities may establish and maintain a pure cash reserve by depositing a predetermined amount of cash into a separate account at the time securities are sold to investors. Interest income earned on the reserve may be added to the reserve balance or withdrawn, depending on the terms of the contract.

Although existing government-sponsored residential mortgage markets do not require cash reserves, private issuers of conventional mortgage-backed securities, at times, establish cash reserves in conjunction with other credit enhancements. In the event of payment delays, the issuer draws down the reserve as necessary to provide payments to investors. The initial size of such a reserve and the amount maintained--as a percentage of the outstanding principal of the pool--vary according to the risk of the underlying loans and the rating of the security sought by the issuer. The size of a cash reserve also depends on what other credit enhancements have been set up for the security.

Current Usage of Subordinated Participation Interests

The subordinated participation is a relatively new credit enhancement technique that has taken several forms initially and through evolution. Essentially, a subordinated participation is that portion of a loan that a lender does not sell when selling loans in a secondary market transaction. When the lender retains ownership in a portion of the loan, that lender also has the right to receive principal and interest payments on that portion of the loan. In the event of a cash-flow shortage caused by borrower nonpayment on the underlying loans, the lender agrees to subordinate or forego the principal and interest payments that it would receive during a payment period so those funds can be used to make payments to investors holding senior securities--those that receive payments first--during that same period. This security design reduces or eliminates reliance on guarantors other than lenders and poolers. In existing secondary markets, the subordinated portion is retained by the lender or pooler or is sold to investors as a separate class of securities. To make the subordinate security more attractive to investors, in practice, it has been supplemented by other forms of credit enhancements, such as insurance or cash reserves dedicated to protect subordinate security investors.

Some private poolers of conventional residential and commercial real estate mortgages use a security design by which principal and interest payments, when received, are paid first to senior security holders with any excess cash being disbursed to subordinated security holders. One characteristic of this type of security design is that unless specified otherwise, only the current payment--whether it is monthly, quarterly, or annually--to the subordinate holder can be used to pay cash-flow shortages to senior security holders; no past or future payments to subordinate holders can be used. Having no recourse beyond the current payment period could limit risk to the lender and shift that risk to secondary market guarantors in periods where large cash-flow shortfalls occur in a short time rather than over a period of time.

To guard against this risk and provide additional credit enhancement to the investors, poolers and lenders holding subordinated participations sometimes establish a small cash reserve--referred to as a liquidity reserve--for disbursing cash to investors who hold senior securities. The liquidity reserve has been established by lenders or poolers depositing a certain amount in the reserve when the loan is pooled or by escrowing into the reserve a certain percentage--generally less than 1 percent in housing markets--of each month's cash flow to the subordinate security holder. The amount of the liquidity reserve, at times, is

determined by rating agencies who set formulas based on other credit enhancement and the ratings desired for a given security.

Unclear What Effects the Use of Subordinated Participation Interests Versus Cash Reserves Will Have on Government Risk

The legislative history indicates that the government did not want to be exposed to major risk through Farmer Mac. One method of reducing government risk was to allow poolers to establish cash reserves or subordinated participation interests to ensure payments to investors. When borrowers make payments of principal and interest on loans backing up a pool, these payments are used to pay investors who hold the securities backed by the pool. The cash reserves and subordinated participations are provided for this market so that, in the event that borrowers do not make payments as scheduled, funds are available from poolers and lenders rather than from the government to pay investors to make up shortfalls. However, even with a cash reserve or subordinated-participation-interest level of at least 10 percent--the level required by the implementing legislation--Farmer Mac and the government may be exposed to risk.

The act states that a pooler must take full recourse against reserves and subordinated participations; but because the act does not specify the mechanics of either, it is not clear exactly what full recourse entails. In the case of a cash reserve, full recourse would probably apply to all cash in the reserve. With a subordinated participation, full recourse would be according to the specific terms set out in the subordinated participation agreement. Since subordinated participation is not yet sufficiently defined to determine what full recourse entails, the financial and risk implications of full recourse to the subordinated participation cannot be determined. Until it is determined how the subordinated participation or cash reserve will be structured, the comparative risk implications to the government when using either of these for Farmer Mac-guaranteed securities cannot be determined. However, to the degree that limitations are put on the ability of poolers to collect cash-flow shortages--resulting from nonpayment by borrowers--from a subordinated participation or cash reserve, Farmer Mac and potentially the government will be expected to make up the difference.

The most critical concern in structuring a subordinated participation or a cash reserve focuses on how likely it will be that cash-flow shortages from borrower nonpayment will exceed cash reserves or the amount of shortages that can be obtained from subordinated holders to pay to investors. If it is likely that

payment shortages will exceed the cash reserves or the amount that may be obtained through recourse to the subordinate security holders, then the question focuses on who will provide the guaranteed payments to investors. Unless Farmer Mac is able to make up that shortfall through other mechanisms, such as liquidity reserves and risk-based fees, it may have to activate its $1.5 billion line of credit from the Treasury. If that were to become inadequate, the government's implied backing of the "agency" would be tested.

The ultimate potential loss to the government under this scenario would be reduced by the amounts--minus collection costs--that could eventually be collected from those nonpaying borrowers through normal collection procedures including extreme measures, such as foreclosures and liquidation of borrower assets.

Options to Be Considered

Cash reserves maintained at a certain percent of the outstanding balance of a pool--at least 10 percent in Farmer Mac's case--will provide greater protection to the government than cash reserves that can be drawn down; however, cash reserves that are maintained at a certain level could be more costly to lenders and poolers. Subordinated participation interests provide varying levels of protection to the government depending on the mechanics of the full recourse the government has to subordinated participation interest holders. Costs to these holders can also vary depending on the amount of recourse.

In the short run, cash reserves are likely to be more costly credit enhancements for lenders and poolers than a subordinated participation interest as used in practice today (see discussion above) because more cash--at least 10 percent--must be provided up front when using the Farmer Mac-specified cash reserve. In the long run, the cost for lenders and poolers would depend on the actual mechanics of the cash reserve and subordinated participation. As indicated previously, subordinated participation and cash reserves are not yet sufficiently defined and their comparative risk implications to the government cannot be determined. However, a cash reserve may be a less risky method for the government in both the long and short run because it provides assurances that the agreed-upon cash amount will be available at all times, versus relying on future collections of cash-flow shortages from subordinated security holders. The competing congressional concerns about (1) minimizing up-front cash-flow needs by lenders or poolers and (2) containing government risk exposure could be addressed through various cash reserve and subordinated participation structures or other credit enhancements. Many options are certainly available to address these concerns.

Some options presented below could be used singularly or in combination to achieve the most desirable credit enhancement package.

-- Subordinated participation interests could be adjusted above 10 percent to better ensure that defaults over 10 percent will be covered by the subordinated securities' current cash flows--the higher the subordinated participation interest, the more cash flow is available to cover nonpayments.

-- A combination of cash reserves and subordinated participation interests could be used.

-- A liquidity reserve escrowed from current cash flows or initially deposited by the pooler/lender could be established to provide some back-up cash to pay current cash-flow shortages that are beyond the current cash flow from the subordinated security.

-- A subordinated participation could be used to allow total and immediate recourse to the pooler or lender in the amount of the cash reserve that the lender and pooler could have elected to contribute to as an alternative to subordinated participation interests.

-- A subordinated participation could be used to allow recourse on each payment period's cash flow to the lender or pooler up to the amount of the cash reserve they could have elected as an alternative to subordinated participation interests.

-- Private mortgage insurance could be required on loans sold into the pool or on the subordinated portion only.

-- Crop insurance on all or part of a loan could be required to help ensure cash flow in the event of failed or poor crops.

-- Geographical and/or commodity diversity could be broad to try to minimize risk in the portfolio.

-- Risk-based fees on individual pools could be raised.

These modifications could result in a profit-margin squeeze for participating lenders and poolers because of potential added costs. Depending on the competitiveness of the market, this could also result in higher costs of credit to the borrower.

Some Farmer Mac representatives we talked to indicated that strong certification standards for poolers may reduce the need for monetary credit enhancements. They said that strict requirements for poolers to monitor loan originators, especially appraisal practices, could reduce the potential risk in the market. In addition, the offering circular for Farmer Mac stock states that the interim board recommended that the permanent board establish a minimum capital requirement of $2 million for certified poolers, which Farmer Mac representatives said would help to ensure the financial integrity of the market. These measures could help ensure that risk parameters set out by Farmer Mac are met but still do not resolve the questions concerning timing and amount of recourse to subordinated participation interest holders for loan pool losses.

WILL THE PRESCRIBED RISK-BASED FEES BE ADEQUATE FOR FARMER MAC?

A pooler is to pay to Farmer Mac an amount not to exceed 0.5 percent of the amount of the initial principal of the pool plus up to 0.5 percent of the outstanding balance of the pool each year to be used as Farmer Mac's risk-based fee. In the event of borrower's nonpayment of loans backing securities guaranteed by Farmer Mac and after all other cash reserves or subordinated participation interests are exhausted, these fees are used as a last resort to pay security holders before Farmer Mac draws on its own resources or its line of credit to the Treasury to make good on its guarantee. If Farmer Mac cannot maintain timely payment of principal and interest on the loan pool, then it may need to draw on the Treasury.

Since historical information on default rates for agricultural real estate loans is limited, it is difficult at this time to determine whether a risk-based fee of 0.5 percent initially and per year will be adequate. In residential markets where such data exist, a minimum, rather than a maximum rate is set. It is not normal practice to set a maximum rate for such a fee in a secondary market because the fee then could cease to be based on risk. Instead it could become more of a management decision reflecting political or economical factors not necessarily risk-related. Setting risk-based fees requires reliable historical information on default and foreclosure rates that currently does not exist for agriculture.

The risk-based fee does not necessarily operate independently of other credit enhancement mechanisms. For example, adjustments in the amount of cash reserves or subordinated participation interests can be made in conjunction with the risk-based fee rates to cover these expected losses. Such an approach, however,

requires the need for a great deal of flexibility on Farmer Mac's part.

An additional consideration is presented in the offering circular for Farmer Mac stocks--that the primary source of funding for Farmer Mac operations will be the risk-based fee. Even though a portion of the fee is to be set aside by Farmer Mac in a segregated account as a reserve against losses from guarantee activities, there may be a constant draw-down of this fee for daily operations of Farmer Mac. Neither the act nor the offering circular defines what portion will be set aside.

WHAT IMPLICATIONS DO SEC REGISTRATION AND DISCLOSURE REQUIREMENTS HAVE FOR FARMER MAC-GUARANTEED SECURITIES?

The act requires that securities offered to the public and backed by a Farmer Mac guarantee must be registered with the SEC. The Securities Act of 1933 requires issuers to file with the SEC a registration statement and a prospectus before offering the securities to the public. The purpose of registration is to ensure full and fair disclosure of information about the company, its management, and the intended use of the proceeds from the issue. These disclosures are meant to help potential investors make investment decisions on an informed basis, not to make investment recommendations to them about the registered securities. The disclosures include (1) financial information, such as audited financial statements, (2) underwriting standards, and (3) nonfinancial information, such as management capability, character of borrower, and potential risk factors associated with the industry and the issuer's business.

Certain issues relating to the registration of Farmer Mac-guaranteed securities include (1) risk-premium implications of registering these securities when other federally chartered agencies are not required to do so, (2) rating implications for other "agency-market" securities stemming from the rating of Farmer Mac-guaranteed securities, and (3) the costs incurred in complying with SEC registration requirements.

Other "Agencies" Not Required to Register With SEC

Other government-sponsored agencies--such as Fannie Mae and Freddie Mac--are not required to register their securities with the SEC. However, Freddie Mac, Fannie Mae, Ginnie Mae, and SBA officials told us they routinely disclose information to potential investors about the pools of loans backing the securities. Since SEC registration is not required for other "agency" securities, the investment community is uncertain about how potential investors

will perceive the riskiness of Farmer Mac securities as a result of the Congress's decision to treat those securities differently.

Some investment bankers told us that investors will "look through" the actual portfolio risks and treat Farmer Mac securities as low-risk investments because of the implied backing of the government, as they do other "agency" securities. According to Standard and Poor's officials, this would probably be true only until, if at all, Farmer Mac guarantees exceed the $1.5-billion--the amount available to it from the Treasury--line of credit. At that time investors could become much more concerned about the quality of the loans and underwriting standards. An implication is that, at that time, more stringent underwriting standards may be needed to build the investors' confidence in the securities. Until then, investors may be willing to accept about the same returns on Farmer Mac securities as they do on other "agency" securities. As a result, if these market savings are passed through to agricultural borrowers, their cost of money may be kept down.

Rating of Securities

Another issue is whether Farmer Mac securities will receive a credit rating from rating agencies such as Standard and Poor's and Moody's Investors Service and, if so, whether such ratings would set a precedent leading to rating other domestic "agency" securities. The act does not specify that a rating for credit risk evaluation be performed for these securities, although many experts believe that such ratings would be done.

Currently, all agencies receive favored status in the capital markets because of implied government backing, but some experts indicate that rating one security--Farmer Mac--could lead to rating all "agency" securities. Some experts are concerned that if individual agency securities were rated in the United States, such a rating practice could increase the agencies' cost of credit because a rating brings into question the government's willingness to stand behind the agencies. Rating agency personnel also told us that if each U.S. "agency" were rated, the cost of credit to the agencies could rise because some agencies could receive lower ratings than others, which would require them to pay higher risk premiums to investors. The congressional intent and historical willingness of the government to sustain a given agency's programs would be an important factor in determining whether an agency were to receive a favorable rating.

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Costs of Registering With SEC

An issue that has been raised by potential poolers of and investors in Farmer Mac-guaranteed securities is whether the additional cost of registering these securities with SEC would adversely affect the volume of loans originated and sold in the secondary market and increase the cost of credit to borrowers. Some are concerned that these additional costs could reduce poolers' profits and/or increase costs to borrowers. SEC regulations require issuers to disclose estimated costs of issuing and distributing the registered securities. Issuers generally itemize these costs into several categories including (1) SEC registration fees, (2) rating agency fees, (3) printing and engraving fees, (4) legal fees, (5) accounting fees, (6) trustee services fees, (7) state fees, and (8) miscellaneous fees.

Information was not available on these eight cost categories for "agency" securities because other agencies are not required to register their securities with the SEC. Therefore, we talked with SEC officials to determine how we might obtain information on these costs. They suggested we review all initial public offerings of mortgage-backed securities registered with the SEC in 1988, which had complete information on these categories. We found 21 such securities, none of which were directly guaranteed by the government or a government-sponsored agency although they included other kinds of credit enhancements. The amount of securities offered ranged from $10 million to $1.4 billion, and the issuers' estimated costs--based on the eight categories--of issuing and distributing securities ranged from $250,000 to $4,915,000. A summary of these 8 cost categories for the 21 registration statements we examined is shown in table III.1. The range in dollars represents the highest and lowest costs of each category for all the registration statements, and the range in percent of amount offered represents the highest and lowest percentages for each category for all the registration statements.

Table III.1: Cost of Registering Securities With the SEC

Cost categories	Range in dollars		Range as percent of amount offered	
	Low	High	Low	High
SEC registration fees	$ 2,000	$ 290,000	.020	0.020
Rating agency fees	14,000	500,000	.005	0.450
Printing and engraving fees	15,000	550,000	.010	1.000
Legal fees	75,000	2,500,000	.020	2.000
Accounting fees	5,000	350,000	.003	0.350
Trustee fees	7,000	1,003,000	.004	0.250
State Fees	4,750	72,000	.001	0.012
Miscellaneous fees	5,000	200,000	.001	0.067

The wide range in costs for these eight categories makes it difficult to use these data for drawing conclusions on the expected cost of SEC registration of agency securities, such as those that would be guaranteed by Farmer Mac. However, we determined that (1) two cost categories--SEC and rating agency fees--were incurred as a direct result of SEC registration and the absence of "agency" exemption status, (2) while SEC fees would likely be incurred by Farmer Mac, rating agency fees would be incurred only if Farmer Mac is rated, (3) costs from the other categories would likely be incurred to some extent by "agencies" because they usually disclose information on pools of loans backing securities along with other pertinent information, and (4) these other costs may be higher with SEC registration than without because SEC's regulations call for the disclosure of more detailed information and would likely require more legal work.

The amount of the SEC registration fee is calculated according to SEC's regulation--currently $0.02 per $100 of amount of securities offered. The other cost categories vary according to a combination of factors, such as type of expenses involved, amount offered, and complexity of the security structure.

Because of these potential added costs, a profit-margin squeeze for participating lenders and poolers could result. Depending on the competitiveness of the market, this could also result in higher costs of credit to the borrower.

The conference report that accompanies the act states that the conferees were presented with conflicting information concerning spreads in interest rates--that would be caused by SEC

registration--between government securities and AAA-rated corporate securities. As a result, the conference report requires the Secretary of the Treasury, in consultation with the SEC and the Board of Governors of the Federal Reserve System, to prepare a report for the Senate Committee on Agriculture, Nutrition, and Forestry and the House Committee on Energy and Commerce within 180 days of the first sale of securities guaranteed by Farmer Mac. The report is to include (1) an analysis of spreads in percentages, including whether the spread between such securities and other securities issued or guaranteed by government agencies exceeds 0.25 percent, and (2) an analysis of the impact of not treating Farmer Mac-guaranteed securities as government securities relative to other government securities.

WHAT EFFECT WILL THE LOAN-TO-VALUE RATIO IN THE ACT HAVE ON GOVERNMENT RISK?

The act requires that no agricultural mortgage loan will have a loan-to-value ratio greater than 80 percent to qualify for a Farmer Mac pool. Many western and midwestern bankers told us that they do not make agricultural real estate loans with loan-to-value ratios of more than 65-70 percent because of the uncertainty of the market value of the collateral backing the loans. The loan-to-value ratio can be an important factor in how likely it is that in case of a loan default, the pooler will recover the outstanding loan amount. To the extent that this is not possible, Farmer Mac's guarantee may be activated. If Farmer Mac is unable to continue principal and interest payments to the investor from its resources, then the Treasury line of credit may be needed.

To better manage the risk in loan pools, loans in the Farmer Mac pools may have to meet varying loan-to-value ratios because of the legislatively mandated requirement that loans in a pool must be diversified by commodity. Loan-to-value ratios for these loans may vary depending on the collateral backing the loan and the type of commodity produced. For example, a midwestern company that developed standards for making agricultural production loans that it intended to sell recognized that there are differing risks associated with the various commodities produced. Therefore,it varied its loan-to-value ratios from 50 percent for poultry loans to 70 percent for seasonal crops, such as wheat and corn, and to 75 percent for hog and cattle production loans. This raises questions on whether or not real estate loans--that depend on various types of commodity production for repayment and that are eligible to be sold into the Farmer Mac secondary market--should require various loan-to-value ratios to ensure comparable and more manageable risks for loans in the pool.

WHAT EFFECT WILL RURAL HOUSING PROVISIONS HAVE ON FARMER MAC-GUARANTEED SECURITIES AND HOW WILL SUCH LOANS BE PACKAGED?

One of the stated purposes of the act is to enhance the ability of individuals in small rural communities--defined as having a population of not more than 2,500--to obtain financing for moderate-priced homes. The loans cannot exceed $100,000 as adjusted for inflation; the act does not specify a formula for inflation adjustments. The act is silent on whether rural housing loans may be included in pools with agricultural real estate or whether they must form pools consisting solely of such loans. However, the conference report that accompanies the act states that pools composed solely of rural housing loans should include loans that are widely distributed geographically and vary widely in the amount of principal. The conference report also states that, to qualify for a pool, rural housing loans will require specific underwriting standards based on FCS loans to rural residents and on other residential secondary markets. It is unclear whether these standards will be incorporated into the overall Farmer Mac standards or applied and monitored separately from the agricultural real estate portion of the market.

Including rural housing loans with agricultural real estate loans in Farmer Mac pools could complicate the pool formation and risk-pricing since pools could include loans backed by both agricultural real estate and residences. Potential poolers told us that they are concerned that, with residences, pools could be less homogeneous, thus restricting the spreading of risk and the efficiency of the market and increasing costs of administering and operating the pool. Trade-offs will necessarily have to be made between pooling efficiency for rural housing alone and for agricultural real estate and rural housing together.

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STATEMENT OF
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CHIEF NATIONAL BANK EXAMINER
OFFICE OF THE COMPTROLLER OF THE CURRENCY
Before the
SUBCOMMITTEE ON CONSERVATION, CREDIT, AND
RURAL DEVELOPMENT
COMMITTEE ON AGRICULTURE
UNITED STATES HOUSE OF REPRESENTATIVES
SEPTEMBER 27, 1989

Mr. Chairman and members of the Subcommittee, on behalf of the Office of The Comptroller of The Currency (OCC), I am pleased to have this opportunity to comment on the Federal Agricultural Mortgage Corporation (Farmer Mac).

We are actively working with Farmer Mac, the American Bankers Association and the Independent Bankers Association of America to implement the Farmer Mac program. Our efforts have resulted in some success. However, many banks may not find participation in the program attractive.

Under the program, the company that obtains and puts together the pool of loans (the Pooler) must cover a 10% subordinated interest in each group of loans supporting the securities guaranteed by Farmer Mac. There are two basic ways to comply with the subordinated interest requirement: either the Pooler establishes a reserve of cash equal to 10% of the principal amount of the pool, or, it retains a 10% subordinated interest in the pool of loans.

Regardless of the method used to comply, the 10% subordinated interest means that the institution in the subordinated position absorbs the entire first ten percent (10%) of all losses that arise from the loans. This means that the institution retaining the subordinated position bears the entire loss that arises from defaults up to 10% of the value of the loans it has sold to the pool. Therefore, if loan losses are 10% or less, the bank would suffer the entire amount of the loss.

This risk sharing arrangement differs from other types of loan participations that banks normally sell. The usual situation when two or more institutions participate in lending money to one borrower, is to have a pro rata sharing of risk. With pro rata sharing, no one is placed in a secondary, or subordinated, position.

For example, under a 10% pro rata sharing of risk, every dollar of loss that arises from default would cost the participating bank ten cents. If the borrower can't pay, the same ratio will apply to the losses and to any money received from a foreclosure or liquidation action. More importantly, if the loan losses are less than 10%, banks under the pro rata method would suffer a smaller loss than they would if they retained a 10% subordinated position in the loan.

The Pooler does have the option of holding all the subordinated interest or sharing the interest with the originating banks. If the Pooler holds the subordinated interest, the costs to compensate the Pooler for holding the additional risk will normally be passed on to the originator and/or the market to the extent possible.

Based on our understanding of the proposed method of operation, the subordinated interest would be transferred to the bank that originates the loan. Therefore, primary credit risk would effectively stay in the banking system. Neither the transfer of the subordinated interest to the originating bank nor the increased cost would be favorable to National Banks' participation in the program.

As supervisors of national banks, the OCC must make certain that banks have adequate capital. National Banks must maintain sufficient capital and loss reserves in order to minimize the potential for failure of an institution, and thereby reduce the risk to the deposit insurance fund. The determination of the adequacy of capital and reserves is based, in part, on the volume of potential risk in the bank's assets. When a bank sells an asset but retains significant risk, the amount of risk does not change and, therefore, the capital and reserve requirements do not change. Recent events in the Thrift Industry demonstrate the consequences of the failure to prudently evaluate risky assets and the necessary level of capital and reserves when dealing with federally insured deposits.

We do support the development of a secondary market for agricultural loans that will assist in the diversification of risk. Farmer Mac securities provide a means for diversifying one type of risk and the potential for effectively diversifying additional types of risk in agricultural lending. It also increases the ability of the local financial institutions to provide agricultural customers with long term financing.

Nevertheless, in our opinion, if banks are required to retain a 10% subordinated interest, as we expect they will be, national banks may not find it economical to participate in the program or their participation will be limited by the amount of capital they have available.

The underwriting standards used also have an impact on the credit risk. But it is important to keep in mind that underwriting standards are not fixed and are susceptible to market influences. In addition, the Act provides the Farmer Mac executive staff with the authority to waive or modify underwriting standards.

Securities issued by Farmer Mac will be in direct competition with securities from similar issuers. Accordingly, market pressure will affect the standards and the viability of the Farmer Mac program. There will be pressure to relax these standards over time if large segments of the agricultural loan market are unable to meet the underwriting standards proposed by Farmer Mac.

Declines in credit standards will increase the risk in the credits and therefore the likelihood of default. Even if the underwriting standards remain consistently high, there is no assurance that the ability of the borrower to repay will continue throughout the life of a long term loan. Most of the increased risk from either situation remains in the banking system.

In every loan there are three basic types of risk related to the collection of the debt: 1) routine credit risk; 2) catastrophic risk; and, 3) interest rate risk. Routine credit risk is the risk in a loan that comes from economic, management and other routine business decisions and fluctuations occurring over the term of the loan. Over time, industries develop historical loss records that may be useful as part of the base for estimating the approximate credit risk of a loan in that industry or geographic area. Catastrophic risk is the risk arising from extensive and/or major economic fluctuations resulting in widespread business failures. Interest rate risk is the risk that results from the rise and fall of interest rates over a period of time.

As presently structured, routine credit risk and a portion of catastrophic risk is retained by the Pooler. This is because the Pooler must cover the <u>first ten percent (10%) of all losses that arise</u> from a pool of loans. We believe the Pooler will require the originating banks to assume these risks as a condition of purchasing loans.

Of the three types of risk listed, loss from credit risk is the greatest risk to the bank. This is because it arises from the decisions made during the course of the routine business activity of one borrower. Generally, minimizing the loss from this type of risk has the highest possibility of success because the situation is generally isolated to the borrower and not widespread as in catastrophic loss. In addition, retaining the first ten percent (10%) loss position potentially reduces the ability of the bank to participate in recovery on a problem credit.

Catastrophic risk, over and above the first ten percent (10%), is assumed by Farmer Mac who guarantees prompt payment in full to the purchaser of the securities. This type of risk, while more devastating when it occurs, fortunately does not occur with any regularity. As recent events have shown, because of catastrophic risk's widespread effect, the possibility of loss recovery is comparatively small and may cover long periods of time.

Interest rate risk is the primary risk being assumed by the purchaser of the security. Transfer of interest rate risk out of the banking system to the investor on long term fixed rate loans is a positive step.

The current structure of the Farmer Mac program transfers the majority of catastrophic credit risk to Farmer Mac. Primary credit risk remains in the Pooler, who we expect will shift the burden of this risk to the originating bank. To increase the benefits of the program, the disproportionate credit risk as well as interest rate risk, should be transferred out of the originating bank or reduced to such amount as to be immaterial, individually and in total. Pro rata sharing of risk accomplishes this purpose.

The Farmer Mac program has the potential for significant benefits. As structured, however, we believe the risks and costs outweigh the benefits. Under the current structure, a participating financial institution is faced with severe restraint and/or material costs with regard to:

- Risk diversification;
- Flexibility;
- Legal lending limit capacity; and
- Capital requirements,

while obtaining only the benefits of reduced risk from long term fixed interest rates and catastrophic loss.

Risk Diversification. The current Farmer Mac proposals provide that the investor in the securities would look only to Farmer Mac for timely payment. The authorized Poolers of the loans also bear no risk from credit or interest rates unless they choose to retain some risk. If they choose to retain risk, the Poolers would need to increase the costs to the originating bank in proportion to the risk retained.

The result is that, unless the Pooler chooses otherwise, the bank would be required to retain primary credit risk on the "sold loan" via a 10% subordinated position in the loan (the first 10% of all loss is absorbed by the bank). Farmer Mac retains the catastrophic loss risk via its guarantee of the securities. The net effect of the current proposed form of operation places 100% of the remaining credit risk on financial institutions. If this credit risk results in losses that exhaust the bank's capital, the ultimate support is provided by the deposit insurance fund.

Flexibility. An investor in Farmer Mac securities will expect to get paid regardless of the ability of the farmer to pay. The investor will look to Farmer Mac for payment. Farmer Mac in turn looks to the Pooler and loan servicer (expected to be the original lender) to require the borrower to conform to the original terms of the loan.

The lending bank's ability to work with a troubled borrower will be limited if the loan has been sold into the Farmer Mac program. In this case, forbearance can only be shown if the originating lender is prepared to repurchase the loan from the Farmer Mac Pooler and restructure the entire loan. If the borrower is experiencing significant financial difficulties, the borrower will probably not be able to satisfy Farmer Mac's credit underwriting standards and the loan will not be eligible for readmission to the Farmer Mac program.

As with any loan securitization program, originating lenders who are faced with this type of unavoidable inflexibility will undoubtedly prove to be less compassionate lenders. Translated into practical everyday language: a financial institution's flexibility to work with, defer payment or reset a financially troubled borrower's credit obligation is reduced, and perhaps eliminated, by participation in the Farmer Mac program.

Legal Lending Limit Capacity. As previously stated, the bank's subordinated interest in the Farmer Mac loan provides recourse to the originating bank for all initial loss on the credit up to a stated percentage. If the bank holds the 10% subordinated position in its own loans sold to Farmer Mac, the lending limit for one borrower will apply. The full amount of the loan sold into the Farmer Mac program is still counted since the repayment risk has not been transferred from the bank. That is because every loan sold into the Farmer Mac program will cause the bank to have the potential for a 10% loss (10% subordinated interest).

In the normal course of business however, some loans will have higher than 10% loss while others will have a lower level of loss. At the current 10% subordination level required by Farmer Mac, the approximate historical loss in agricultural credit would probably be covered several times, effectively guaranteeing repayment to the investor by the originator.

For example, if the average historical loss in agricultural credit is $3 for every $100 loaned, the bank's 10% subordination interest, or $10 loss coverage; is 3.3 times the normal credit loss to be expected from such loans.

Capital Requirements. The same situation is true for calculation of risk based capital requirements which becomes effective December 31, 1990. At that time, the full amount of the loan would be included in the capital requirement for this type of credit.

Why? Risk based capital captures credit risk, even though it has been transferred off the balance sheet. In this case, capital requirements are based on the volume of risk in the assets and are designed to minimize the potential for failure of an institution. Since the first 10% of loss in the loan is still held by the bank, credit risk is not fundamentally transferred.

Therefore, because the bank would continue to hold the credit risk, it will need capital to offset the potential risk. For example, the bank makes a $1,000 loan and historical risk is estimated at 3% or $30 (historical risk is based on the bank's estimate that all loans of this type have lost and will lose $30 per $1,000 on average). The bank sells the loan and retains the 10% subordinated interest.

Having sold $900 of the loan, they now have a $100 balance on the books. But, because they retain all of the first 10% risk of loss from the whole loan, the bank still retains the $30 historical risk. The historical risk is now 30% of the bank's balance on the loan as opposed to the original 3%.

If there was a pro rata sharing of risk, the potential risk would remain at the 3% level, or $3 after the sale. This is because all participants would share equal to their interest (pro rata) in all profits and losses. Accordingly, under the Farmer Mac program, the bank is more limited as to the volume of activity each dollar of capital will support when compared to activity based on pro rata risk sharing.

Under the proposed Farmer Mac structure, the program provides some benefits. However, benefits must be real and not just shift the costs from one expense category to another. One real benefit is that long term interest rate risk is eliminated for each loan sold into the program. Additionally, the sale of the loan does generate funds that may be used in an unrelated investment.

However, if the subordinated position is held by the bank, a number of possible benefits are not realized. Capital cost is not improved and capacity to lend additional funds to the same borrower is not increased. Overall, the combination of the capital cost, legal lending limit restrictions and the bank's loss of flexibility to work with the borrower, may reduce widespread participation in the program by national banks.

The overall condition of the bank will not be enhanced by keeping subordinated interests in sold loans. From a credit evaluation standpoint, a subordinated position in a long term loan, which is the last portion of a credit to be paid, is the least favorable position to hold.

Therefore holders of subordinated portions of loans usually receive some criticism of those loans. This criticism could come from the bank's own internal loan review process, internal and external auditors, or its primary regulator. Economic decline would practically assure classification as a problem credit, which in turn would result in even higher loan loss reserves.

In the bank, losses in subordinated debt would appear well in advance of loss conditions in non-subordinated credits. This is because of the lack of ability to participate in normal collection processes for this type of loan, placing the bank in the position of being the last to collect.

Farmer Mac would be paid first from the sale of collateral. At some time in the future, in the unlikely event that any assets or funds remained, the bank would then be able to pursue its claim. However, in reality, the bank as subordinated holder is basically in an unsecured position.

Active participation in the program by banks holding a 10% subordinated position would result in the accumulation of long term subordinated interests from many loans. Without adequate capital and reserve requirements, this accumulation of risk would result in an unacceptable amount of potential loss to the bank.

A large volume of loan sales by a bank into the current program may also result in the total of all the 10% subordinated interests to be criticized on the basis of volume. A large volume of loans originating from one source (the source being the combined subordinated debt positions) contains greater risk than if the same volume arises from many sources with differing means of repayment. In this instance, the "source of repayment" of the bank's portion of the debt is always <u>the last funds to be received in repayment or liquidation of the debt.</u>

Further increasing the bank's risk in this volume of credit is the fact that loans are probably concentrated in certain types of agriculture and many of the borrowers are likely to be in interrelated businesses. Thus, local economic or natural occurrences will have direct impact on a significant portion of the borrowers and their ability to pay their loans.

Mr. Chairman, we appreciate the opportunity you have afforded us today. We will work with you, the Farmer Mac staff and the industry groups attempting to formulate a sound method of operation.

Prepared remarks by
James A. Parrish
Vice President & Associate Director
Moody's Investors Service

Mr. Chairman and members of the subcommittee:

I appreciate this opportunity to provide you with Moody's thoughts on the credit risks associated with the establishment of the Federal Agricultural Mortgage Corporation (or Farmer Mac). Specifically, I will address the risks we see in the underwriting standards being proposed for the new entity -- including standards for both loan diversification and appraisals, as well as the eligibility standards for Certified Facilities or "poolers." I will also give you Moody's perspective on the likely market acceptance of securities that carry the Farmer Mac guarantee.

First, I'd like to give you a brief overview of Moody's and of our Structured Finance Group. Founded in New York at the turn of the century by John Moody, Moody's Investors Service has been rating the creditworthiness of debt securities since 1909. Today, we rate well over 40,000 corporate and government debt securities worldwide. In the process, our analysts follow more than 3,000 issuers of debt ranging from sovereign nations and financial institutions to industrial enterprises. We also rate the credit risk of several thousand structured finance issues, which is the area I am representing today.

As you are probably aware, structured finance is a fast growing and increasingly complex form of debt financing. Essentially, it involves the packaging of financial assets for resale in the credit markets as debt securities. Traditionally, most structured financings were securities backed by home mortgages; but today, structured financings may include the repackaging of asset types that range from commercial mortgages to automobile loans and even corporate bonds. The securities themselves may be offered to investors in a wide variety of structures -- including bonds, pass-throughs, and other securities such as those that may be guaranteed by Farmer Mac.

In evaluating the credit risk of structured securities we call upon the analytical expertise of industry experts throughout Moody's to assess not only the potential default risk of the assets backing the security but also the risks inherent in each particular security's cash flow and legal structure.

Given that introduction, let me speak first to the proposed underwriting standards for Farmer Mac. One approach to addressing those standards would be to go point by point in evaluating the criteria presented in the proposed guidelines. However, Moody's does not ascribe to a formula-driven approach to credit analysis. Perhaps the best way to describe our approach would be to outline how Moody's evaluated a recent 365 million dollar Vendee loan sale by the Veterans Administration. In assessing all such financings, Moody's uses a building block approach that combines quantitative rigor and qualitative judgment. In the V.A. sale, our approach included an evaluation of:

(1) The underlying assets (Vendee loans).
(2) The practices and procedures of the originator, the seller, and the servicer.
(3) The structure of the security, that is, the priority of its cash distributions, its credit support, etc., and finally,
(4) The legal risks.

We based our evaluation of the vendee assets on more than 3 1/2 years of quantitative analysis of historical default and delinquency data on more than 8 million conventional and government residential loans. The data studied, which includes the experience of the private mortgage insurers, the F.H.A., the V.A., and the Mortgage Bankers Association, dates from the early 70's and also includes statistics from the Great Depression. The results of this analysis were combined with expectations about geographic regions, industries, and certain economic forecasts to predict the probable future performance of the pooled assets. In rating the V.A. sale, Moody's findings were applied to the specific pool characteristics and to the delinquency and default statistics of the Vendee loans to quantitatively assess the expected losses on the portfolio.

Next, a team of analysts visited the loan origination and servicing facilities to evaluate the operations and the ability of management to service the loans going forward. The findings of these meetings were reviewed by the rating committee and incorporated into the projection for future portfolio losses.

We then focused on the deal's structure. In this case, the V.A. chose a structure similar to that proposed for Farmer Mac securities, whereby the pool of loans is divided into senior and subordinate portions. Approximately 50% of the V.A. portfolio was subordinated to protect investors from incurring default losses on the senior Aaa-rated securities.

A statistical method was used to determine the credit quality of the rated securities. In addition, the receipt and distributions of monthly cash flows were examined to determine whether third-party bankruptcies insolvencies could have an impact on the quality of the rated securities.

Finally, the legal nature of the issue was reviewed to assure that the rights of the senior certificateholders would not be impaired by others claiming ownership interests in the underlying Vendee loans. Moody's then combined the results of the quantitative analysis of the pool and structure along with the qualitative assessment of the originator/servicer and the legal nature to determine the individual credit strength of the structured security.

Now, what I've just described is an application of Moody's general approach to credit analysis -- a combination of empirical analysis and judgment. We suggest that Farmer Mac employ a similar strategy in assessing the credit quality of the underlying agricultural loans and the structural strength and legal risks of securities to be offered to investors.

In doing this, the first step Farmer Mac should take, is to analyze the historical pattern and magnitude of losses for agricultural mortgage loans. This process will involve developing a comprehensive data base on delinquencies, defaults, and recoveries for these loans. Using this data base, Farmer Mac should then identify the important factors that cause losses and use this information to create a model that can project future losses. Two points should be noted here, (1) not all of these factors can be quantified in a statistical model; and (2) all the factors that affect losses should be projected into the future.

For example, in Farmer Mac's case, they must project regional, national and international economic conditions to assess the future worldwide demand for specific agricultural products. Political considerations both here and abroad should be factored in, particularly farm trade and subsidy policies. The effect of changes in consumer tastes, such as shifts toward a preference for naturally produced goods, should be weighed. The impact of innovations in technology should also be considered, as should the effects of recent weather patterns worldwide.

In other words, as we at Moody's have found, simply relying on historical data to predict the future is a somewhat tenuous proposition. Instead, the historical data should be used as a base, and then adjusted to reflect an assessment of the current and probable future conditions that could devalue the underlying collateral This requires the use of reasoned judgement tempered by experience.

We have also found that the pool-specific characteristics that determine credit losses cannot be captured by a rigid, pass-fail, formula-driven approach. A thorough evaluation by Farmer Mac would require an evaluation of the financial strength of the seller/servicer and on-site operational reviews to assess origination, appraisal, and servicing procedures. Additional attention should also be paid to the adequacy of the servicer's computer backup systems and its ability to provide accurate investor reports. In addition, Farmer Mac must diligently monitor originator and servicer practices to ensure continued adherence to its standards.

However, even if Farmer Mac uses its best judgment to adjust historical loss numbers, other factors should be considered. Credit analysts must recognize that even their best guess regarding portfolio losses is only that: a guess. Therefore, an evaluation of how variable the outcomes can be is essential to determining how much exposure Farmer Mac has to credit losses.

To evaluate the potential variability of losses on a pool of loans, it is necessary to assess first, the variability of the forces that affect the value of the underlying collateral and, second, the diversity of the collateral. Diversity should be evaluated along many lines, including the number of loans in the pool and the concentrations of geographic locations, crops produced, raw materials used, and export markets.

Once the expected loss and variability of a pool are determined, it is necessary to

combine these measures and the required credit support into a single assessment of the adequacy of the credit support level.

In addition, if Farmer Mac is to operate prudently and in the best interest of the taxpayers it must address all legal and structural risks associated with the securities it guarantees. For example, Farmer Mac must be confident that cash flows will not be interrupted, that third parties cannot make claims upon the collateral underlying the securities, and that all contractual obligations of each party to the transaction are enforceable.

Finally, if Farmer Mac guaranteed securities are to establish a viable secondary market, they must be attractive to prospective originators and investors. In order to participate in this market, originators must have an incentive to originate and sell loan product into the Farmer Mac program. This requires economically efficient credit support levels. In other words, the proper balance must be struck between the first loss position taken by the sellers of the loans and the protection that credit enhancement provides to Farmer Mac and the taxpayers. Furthermore, the attractiveness of pooling loans to meet the Farmer Mac guarantee requirements will depend on the availability and flexibility of pooling entities as well as the evolving regulatory, accounting and tax issues. For instance, bank capital constraints may discourage institutions from holding subordinate interests in Farmer Mac guaranteed securities.

For investors, the attractiveness of the program depends on their confidence in Farmer Mac's ability to manage the complex credit risks that are involved. That confidence will depend on the extent to which Farmer Mac can implement a judicious evaluation process such as the one described earlier. Also, the availability (real or otherwise) of U.S. government support beyond the $1.5 billion will affect investor perception of the credit risk.

In summary, I have described the process by which Moody's analyzes structured financings similar to those that will be guaranteed under the Farmer Mac program. I have also presented you with specific recommendations on how Farmer Mac might evaluate the securities it will be guaranteeing. These include (1) employing a rigorous statistical analysis to determine the historical loss experience on agricultural loans; (2) evaluating the many factors that affect the value of the underlying collateral, including economic, environmental, political, and technological conditions; and (3) carefully analyzing the pool-specific characteristics as well as legal and structural risks. In addition, I outlined some of the considerations that will affect the market acceptance of the Farmer Mac securities.

By way of closing, let me say that Farmer Mac has a formidable task before it. Moody's has found that credit analysis cannot be strictly quantified, nor can it rely solely on a matrix of inflexible standards, nor can it be described precisely by a formula. Instead, prudent evaluation of credit risk must also encompass a qualitative assessment by the analyst. The final evaluation must incorporate analysis, experience, and judgment.

Thank you for the opportunity to share these thoughts with you.

STATEMENT BY FREDERICK R. MEDERO

VICE PRESIDENT - ASSET AND GOVERNMENT FINANCE

KIDDER, PEABODY & CO. INCORPORATED (NEW YORK, NY)

BEFORE THE SUBCOMMITTEE ON CONSERVATION,

CREDIT AND RURAL DEVELOPMENT

OF THE

COMMITTEE ON AGRICULTURE

OF THE UNITED STATES HOUSE OF REPRESENTATIVES

Washington, DC

September 27, 1989

MR. CHAIRMAN, on behalf of Kidder, Peabody & Company Incorporated, I commend you and your colleagues on the Subcommittee for holding this hearing on the implementation of a secondary market in agricultural and rural residential mortgages through the Federal Agricultural Mortgage Corporation. Kidder, Peabody especially appreciates the Subcommittee's invitation to present our views concerning securities market aspects of that implementation process. I had the opportunity to testify last week on this subject before the Subcommittee on Policy Research and Insurance of the Committee on Banking, Fiancee and Urban Affairs. My testimony today, while it in some ways parallels my statements of last week, takes into account the substance of the last week's hearings and focuses more on the particular concerns of this Subcommittee with the implications for the agricultural community.

The Committee on Agriculture and this Subcommittee had a primary role in the fashioning of the Farm Credit Act Amendments of 1987, particularly the Farmer Mac enabling title of the law. The Committee's and Subcommittee's continued interest, as evidenced by this hearing, in the developments to date is important to assuring that the Farmer Mac program is implemented consistent with congressional intent, particularly as it relates to the delivery of real estate based credit to production agriculture and rural communities.

Kidder, Peabody & Company Incorporated. I would like to provide some brief background information on Kidder, Peabody and our involvement in the area of asset finance.

Kidder, Peabody has been in the investment banking business for over 120 years serving a vast array of clients -- both domestic and international, in the private and public sector -- to resolve complex financial needs. In 1986, an 80% interest in the firm was acquired by General Electric Company through its subsidiary, General Electric Financial Services. Among many advantages, this arrangement means that Kidder's capital position of $809 million is augmented by our access to capital and financial products with General Electric.

Kidder's Investment Banking Department includes the Asset Finance Group and the Government Finance Group which specialize in the application of securitization and structured financing technology to create new investment instruments from the cash flows of underlying assets such as residential mortgages, commercial real estate, and industrial, commercial, and consumer receivables, etc. Over the past three years, our firm has established itself as a major participant in the growing mortgage-backed securities market, in which GNMAs, FNMAs, FHLMCs and "whole" (i.e., unguaranteed) loans are packaged and sold to investors in increasingly complex formats.

The Government Finance Group has been an innovator and industry leader in the application of securitization, structured financing, and lease financing technology to the financing of assets and projects of the United States Government, as well as foreign governments.

In addition to the firm's participation in the underwriting of related asset-backed securities, Kidder, Peabody serves or has served as financial advisor to the Farmers Home Administration (FmHA) in connection with the sale of $2.9 billion of rural housing loans; to the Veterans Administration in connection with the sale of approximately $1.2 billion

of Vendee Loans; to the Federal Railroad Administration in the disposition of approximately $200 million of portfolio securities; to the Pennsylvania Avenue Development Corporation in the financing of the second largest federal office complex ($461 million); and to the Government of Israel in connection with the refinancing of approximately $5.5 billion of foreign U.S. military sales debt.

At Kidder, Peabody, we believe that our experience in asset finance and government finance relate directly to the structuring and underwriting of the type of mortgage-backed obligations to be guaranteed by Farmer Mac. We continue to support the implementation of a secondary market for obligations backed by agricultural real estate and rural residential mortgages through the Farmer Mac program as an effective means of assuring the availability of a full range of credit options for agricultural producers and rural residents.

General Observations. We would like to offer a few general observations on the implementation of the Farmer Mac program:

- If allowed to evolve based on comparable market dynamics and disciplines, there is every reason to expect that Farmer Mac will achieve success in the agricultural area parallel to that achieved by FNMA and FHLMC in the residential real estate mortgage area.
- If Farmer Mac, originators and poolers are permitted to work-out the details of this program at the retail and wholesale levels, obligations backed by agricultural and rural residential mortgages guaranteed by Farmer Mac can be competitive.
- Farmer Mac has drawn underwriting standards that accommodate various types of agricultural production operations. Those standards are sufficiently specific as to allow originators and poolers to focus lending activity with a view toward pooling loans under the Farmer Mac program.

- Farmer Mac's underwriting standards, when combined with the geographic and diversity standards that have been adopted by Farmer Mac, reflect a dynamic, rather than static approach to risk management. Those standards will be applied on a "by pool", not just on a "by loan" basis. Farmer Mac has wisely reserved the flexibility necessary to adjust certain of those requirements to assure that their application does not unfairly work against certain agricultural areas or commodities.

- There will be adequate opportunity after the first few deals are completed for Farmer Mac and interested parties to review the process, develop constructive criticisms, and make any appropriate adjustments for future transactions. Any exposure to Treasury in the interim from those transactions will be minimal. The requirements for SEC registration and review will assure that the terms of the early transactions will be well documented and disclosed.

- The performance to date of the Farmer Mac board of directors and management demonstrates professionalism and competence, and argues for affording those individuals every opportunity to continue to prove themselves and the workability of the secondary market program that Congress sponsored.

- The focus should be on establishing a climate that encourages institutions that are willing to accept eligibility criteria and ongoing responsibility for loan pools to enter the market as a Farmer Mac poolers. The economics of the market will determine the ultimate number of poolers.

- Regulatory treatment of subordinated interests retained in securitized loans and loan pools threatens the participation of banks in the Farmer Mac program. As those guidelines would be presently applied, no recognition would be given for the substantial credit and interest risk reduction that would accrue to a bank from securitization using the Farmer Mac program, as compared to the risk on agricultural and real estate credit extended outside the program. The goal of encouraging banks to use the secondary market to reduce risk and to serve farmers and ranchers will be frustrated absent flexibility on the part of the regulators.

- Finally, the farmers and ranchers whom Farmer Mac was intended to serve remain very positive and enthusiastic about the potential for the program. However, if enthusiasm for the secondary market is to be sustained and the intentions of Congress fulfilled, Farmer Mac should be encouraged to be in the position to guarantee the first issues of obligations backed by agricultural mortgages by year-end 1989.

Underwriting and Appraisal Standards. A primary area of interest to this Subcommittee is the underwriting and appraisal standards for Farmer Mac qualified loans which are before Congress for review. Since investment bankers are not involved in the business of extending credit directly to production agriculture or rural homeowners, these comments on the standards are addressed primarily to the impact of, and likely market reaction to, rather than the appropriateness of, those standards.

Notwithstanding the Farmer Mac guarantee and the agency status of the obligations, investors will focus on the quality of the loan underwriting and appraisal standards on which the underlying loans are made. Underwriting quality will directly impact the level of defaults, and therefore the predictability of prepayments. The greater the uncertainty, the higher the yield that investors will demand and the lower will be the net return to poolers.

An important feature of the Farmer Mac program which makes it different from GNMA, FNMA and FHLMC is the requirement that poolers and originators absorb the first 10% of any losses incurred on a loan pool, which may well represent virtually all of the loss exposure. Contrary to the suggestions of some, this recourse feature is a strong incentive for lenders, and participating poolers in particular, to favor sound underwriting standards.

Since the subordinate piece of a pool will not carry the Farmer Mac guarantee, the soundness of the loan underwriting standards and their consistent application will be extremely important in determining the marketability of, and yield that investors will require on, the subordinate interest. Poolers will want to have (and in some instances may, for regulatory purposes, may need) the option to sell the subordinate interest.

Finally, the underwriting and appraisal standards will be focused upon by credit rating agencies that may be asked to review the program or specific issues of obligations.

Congress should focus on the process by which the underwriting and appraisal standards were developed. Task Forces of professionals, who are in fact highly expert in the area of agricultural lending and who represent a wide cross-section of financial institutions that lend to farmers and ranchers, drafted the standards under the able leadership of Farmer Mac board members. Those draft standards benefited from wide publication, as well as a public hearing for reactions and recommendations. A number of those recommendations were incorporated into the final standards. It should not be overlooked that comment was solicited and received by Farmer Mac from various groups representing farmers and ranchers, as well as lenders.

Criticism may be heard that perhaps the underwriting standards should be more specific. We believe it is fair to say that the standards are dynamic, as they must be, rather than static. They set out in considerable detail the financial information and ratios by which loan quality will be judged. Yet, they give Farmer Mac the ability to adjust certain aspects of those requirements based on circumstances, to integrate pool diversification standards into the process, and to consider the composite profile of the particular loan pool. This is also necessary to avoid unintended penalization of certain agricultural areas or commodities.

This is a "real world" approach. No standards can anticipate every circumstance, and these standards should be applied on a "by pool", as well as on a "by loan" basis. The success of Farmer Mac will depend not on efforts to anticipate in advance every hypothetical situation that may arise. Rather, success will depend on the ability of honest

and experienced individuals to apply sound, basic credit underwriting standards to varied fact patterns in ways that demonstrate the exercise of good judgement. The strength of a pool of loans, as opposed to the loans taken individually, will determine Farmer Mac's risk exposure. Farmer Mac will be performing its own "stress test" on loan pools, and will rely on poolers to maintain ongoing responsibilities for pools so as to assure their accountability and minimize risk exposure. Farmer Mac's loan underwriting and appraisal standards appear to accommodate such an approach.

There have been suggestions that appraisal standards developed as part of the recent thrift assistance legislation be adopted by Farmer Mac. It should be recognized that the factors that gave rise to thrift industry problems differ considerably from those that beset agricultural lending. The best approach would be not to suggest a wholesale adoption of those standards, but rather to encourage a careful review of the relevance and usefulness of those standards to agricultural and rural residential lending.

Pooler Qualification Standards. The basic eligibility criteria for poolers is set out in the law. Farmer Mac's standards for becoming a qualified facility or "pooler" have been published and subsequently revised. Those standards track the language, and express the intent of the statute.

Among other requirements, a pooler must have a written agreement with originators from whom loans are purchased; monitor underwriting and servicing of pools and verify to Farmer Mac that the functions are being carried out in accord with its standards; have the capacity to audit loan pools and the systems and operations of originators, and verify the conduct of those functions to Farmer Mac; and, make representations and

warranties to Farmer Mac concerning the securities issued and pools of loans backing those securities. Farmer Mac has stated that poolers must maintain responsibilities for pools backing guaranteed obligations, and indemnify Farmer Mac in the event of a breach of those responsibilities. Farmer Mac also represents that where a pooler is a joint venture, those responsibilities and indemnifications will run to all joint venturers.

The approach reflects the specific intent of Congress that poolers be encouraged to extend their commitment to agricultural and rural lending, and to require that poolers have continuing responsibilities for pools that they assemble serve in order to insulate Farmer Mac and the United States Treasury be insulated from loss. The observation has been made that Farmer Mac pooler qualification standards place responsibilities on prospective pooler far greater than those imposed in connection with Government sponsored residential mortgage securitization facilities. This is correct.

Recent experience in connection with the GNMA program administered out of the Department of Housing and Urban Development has shown concerns over pooler responsibilities to be valid. Thus, the qualifications in the law and the related standards do not allow "conduit" operations, and we believe that such operations would expose Farmer Mac and the Treasury to substantial risk.

The pooler eligibility criteria in the law were designed both to strengthen the commitment of lenders to serve farmers and ranchers and to assure that the interests of Farmer Mac (and the Federal Government which ultimately stands behind the Farmer Mac guarantee) are protected by pooler commitments through the life of a pool. Farmer Mac's pooler qualification standards seem to successfully meet both objectives.

Investor Focus It has been observed that emphasis is sometimes placed more on the risks and limited failures in agriculture, rather than on the strengths and far more frequent successes of American agriculture in domestic and global arenas. Farmer Mac can have an important role in adjusting perceptions.

Farmer Mac guaranteed obligations will appeal to a sizeable number of institutional and individual investors. The obligations will resemble, but have some features significantly different from, other mortgage-backed obligations. It may be helpful to consider just how investors will approach the new instruments.

A useful starting point may be to state that Farmer Mac guaranteed obligations will not compete with the notes and bonds of the banks of the Farm Credit System (FCS). FCS bonds are fixed income bonds, while Farmer Mac guaranteed obligations will prepay based on amortization of the underlying mortgages, loan prepayments, and loan defaults. This means that the relative appeal of Farmer Mac guaranteed obligations to investors, and the investors interested in the obligations, will be different than for FCS notes and bonds.

The nature of the underlying credit obligations differ. Investors in Farmer Mac guaranteed obligations must look for repayment primarily to the specific mortgages that back the obligations. Investors in FCS notes and bonds look to the financial position of the banks themselves.

The cash flows will differ. Farmer Mac guaranteed obligations will prepay based on the factors noted above. FCS notes and bonds have fixed maturities.

The yields on the respective obligations will differ. Investors in Farmer Mac guaranteed obligations will demand a significant premium for the prepayment risk assumed. Investors in FCS notes and bonds will accept the traditionally narrow spreads

over comparable Treasury obligations due to the lack of prepayment risk.

Clearly, Farmer Mac guaranteed obligations will not displace the market for FCS notes and bonds because of the fundamental differences noted above between the two types of securities. Investors who would purchase a repayable instrument as an alternative to a FCS note or bond already have an ample supply of mortgage backed obligations from which to choose. Neither the volume of securities to be added to this market by Farmer Mac guaranteed obligations, nor the agricultural profile of those securities will alter this.

Several other observations about Farmer Mac guaranteed obligations should be mentioned. We believe that the pricing of the securities will benefit from the status of Farmer Mac as a government sponsored enterprise and the related "agency" characteristics of the obligations themselves. The spreads over Treasury securities at which Farmer Mac guaranteed obligations of comparable maturity will price will depend largely on the terms of the mortgages in the underlying pool (i.e., maturities, coupons, prepayment options, etc.). Also, some marginal premiums will attach initially due to the scant data available on the prepayment characteristics of agricultural mortgages, the newness of the security, and the relative liquidity of the market in the obligations.

Investors will be interested in several features of Farmer Mac guaranteed obligations which are yet to be defined. One is the terms and timing under which the Farmer Mac guarantee will be triggered. Another (and a related) feature concerns the terms of any subordinated interest in a pool retained as an alternative to posting a reserve.

The law provides some guidance on these issues. For example, it specifies that the guarantee covers both principal and interest on mortgage-backed obligations. Also, the reserve or subordinated interest retained must equal at least 10% of the outstanding

principal balance of the loan pool. Further, the guarantee does not trigger until the reserve or retained subordinate interest is exhausted.

However, the practical implementation of the guarantee terms and subordination terms are must be left to Farmer Mac to resolve in the context of specific deals. We would suggest that this is the only approach under which the Farmer Mac can successfully operate. The subordination approach to credit enhancement is a familiar part of the asset-backed and mortgage-backed markets, and the structuring of the subordinate interest is a critical determinant of investor acceptability and pricing of the obligations.

As examples, we cite our experience with the FmHA sale of rural housing loans and the series of Veterans Administration sales of vendee loans mentioned. In those instances, Kidder, Peabody served as financial advisor to the Federal Government in successfully negotiating and structuring the transactions using credit enhancement in the form of subordinate interests.

Regulatory Capital Issues. When the legislation creating Farmer Mac was considered by Congress, there was a general awareness of certain regulatory issues which would impact on the participation in the program of certain financial institutions, particularly commercial banks. The approach was to leave those issues for resolution through communications with the respective regulators. Unfortunately, as of this date two of those important issues remain unresolved, and they serve as disincentives for bank participation as originators and poolers.

One issue relates to whether an originator selling an eligible loan to a pooler will be required to continue to count the loan against the limitation on loans to one borrower

where a subordinate interest in the loan is retained. Banks, particularly country banks, believe that an inability to gain additional lending capacity through securitization will be a substantial disincentive to originating loans for sale to a Farmer Mac qualified pooler.

Another issue relates to the risk capital which an originating bank will be required to maintain against loans sold to a pooler where the originator holds all or part of the subordinate interest, and which a pooler bank will be required to maintain against loans pooled and sold, but in which the pooler holds the subordinate interest. Absent some regulatory relief, it appears that the entire amount of the loan or the loans in the pool, as the case may be, will require capital support at the full regulatory level (8%).

Kidder, Peabody has joined with others in pointing out the risk reduction benefits that result form agricultural mortgage securitization by commercial banks and FCS institutions using the Farmer Mac program. We have urged the bank regulators to afford banks maximum flexibility in the area of related capital treatment of retained subordinate interests.

We acknowledge that, as with other assets carries by banks, retained subordinate interests should be supported by capital. No one, to our knowledge, has suggested otherwise. But in determining the level of capital appropriate to the risk we believe that strong weight should be given to the substantial credit and interest rate risk reduction consequences that flow from securitizing through use of the Farmer Mac program, which argues for assigning a weight at the 20-30% level. Finally, we suggest that such a weighing be applied for a period adequate to assess risks based on experience (5 years), with the option to both intervene as necessary against an institution using the regulators substantial (and recently strengthened) supervisory powers and to and to revisit the entire issue of

capital treatment at the end of the test period.

We believe that the elements necessary to resole the risk based capital issue are at hand if the regulators are willing to work through the problem. The positive impact that Farmer Mac will have on the quality of agricultural lending, such as by setting an industry-wide standard, should be welcomed and encouraged by the regulators.

However, we also believe that absent speedy and flexible resolution, this issue may prove to be a major obstacle to participation in the secondary market. If this turns out to be true, we fear it will frustrate Congress' intent to encourage bank lenders to expand credit services to farmers and ranchers through participation in the secondary market as Farmer Mac qualified originators and poolers. Farmers and ranchers and the banking system will suffer as a result.

Mr. Chairman, Kidder, Peabody applauds the Committee's and Subcommittee's initiative in holding this hearing, and we appreciate the opportunity to present our views. We hope that this hearing will facilitate the resolution of issues such as those relating to risk based capital treatment of retained subordinate interests and encourage Farmer Mac to move forward to being in a position to guarantee issues of obligations backed by agricultural mortgages by year-end. It would be unfortunate if another season were to pass without farmers and ranchers having the benefits that Congress intended when it enacted the Farmer Mac legislation. I would be pleased to respond to any questions that members of the Subcommittee may wish to ask.

(Attachments follow:)

Kidder, Peabody & Co.
Incorporated
Founded 1865

10 HANOVER SQUARE
NEW YORK N Y 10005

Frederick R. Medero
VICE PRESIDENT

May 8, 1989

Mr. J. Michael Shephard
Senior Deputy Comptroller
Office of the Comptroller of the Currency
490 L'Enfant Plaza, SW
Washington, DC 20219

Dear Mike:

I just want you to know how much I enjoyed seeing you last Friday and getting the chance to discuss the current status of the Federal Agricultural Mortgage Corporation (Farmer Mac). As I mentioned, Farmer Mac held a public forum the same day on its draft loan underwriting and appraisal standards which will soon be finalized and transmitted for Congress' review.

Farmer Mac has the potential to help farmers and ranchers by bringing national banks into the business of making long-term loans secured by first-lien mortgages on agricultural real estate and rural residences at both fixed and variable rates. Banks would be able to offer a full range of credit services to farmers and to better match-fund those credits by selling pools of loans in the form of mortgage-backed obligations guaranteed by Farmer Mac as to the timely payment of principal and interest. Banks may be able to participate in the program as originators of agricultural mortgage loans and as poolers of those loans. A requirement of the program is that the originators/poolers establish a cash reserve or take a subordinate interest of at least 10% of the principal amount of the loans outstanding in a pool.

A critical issue has arisen which may have very negative implications for participation by national banks in Farmer Mac. Under a December 21, 1988 letter from the Federal Financial Institutions Examination Council, banks will be afforded sale treatment on Call Reports for loans securitized and sold with the Farmer Mac guarantee to the same extent that such transactions are sales under generally accepted accounting principles. However, banks that sell loans to a pooler or that pool loans and sell mortgage-backed obligations and retain the required subordinate interest equal to or in excess of expected losses on pool loans will be required to maintain capital at the level of 8% for the entire pool under the Comptroller's Risk Based Capital Guidelines. In addition, banks that sell or pool loans and retain a subordinate interest will not be able to exclude the loans for lending limit purposes under 12 USC 84.

There are a number of valid reasons for the Comptroller to take a favorable view toward the implementation of Farmer Mac and its utilization by national banks.

o The most important objective in creating Farmer Mac was to make long-term credit available to farmers and ranchers. Farmer Mac will make it possible for national banks to enter an area of profitable lending activity (i.e., long-term agricultural mortgage lending) from which they have heretofore been precluded because of an inability to engage in prudent asset/liability management. This new lending activity would be a stable source of earnings and enable national banks to better serve farmers and ranchers.

o National banks that make agricultural mortgages that back securities carrying the Farmer Mac guarantee will be able to shed the interest rate risk associated with those loans. Although not the focus of the Capital Guidelines, interest rate risk is an important factor affecting safety and soundness.

o The underwriting and appraisal standards established by Farmer Mac for agricultural mortgage loans sold into the secondary market will have a very positive impact on agricultural lending generally. Mortgage loans sold into the secondary market will set the standard for what is a good loan and thus promote better credit analysis and practices. Agricultural lending practices and documentation will become more standardized across-the-board in a way not dissimilar to what has transpired in the residential housing area with the attendant benefits to homeowners. Lenders will have greater control of the credit risk associated with their short and intermediate-term agricultural lending (to which the Farmer Mac guarantee does not apply) as they are able and willing to extend credit to farmers across the maturity spectrum.

For these reasons, I would suggest that the treatment under the Capital Guidelines of agricultural loan pools in which national banks retain subordinated interests deserves additional consideration by the Comptroller. Two important points should be mentioned concerning the risks associated with subordinated interests retained by banks in pools of agricultural mortgages.

1) The agricultural mortgage loans in a pool will be have been made under Farmer Mac's high credit underwriting and appraisal standards and therefore should present minimal credit risks. In addition, pools will be required to meet geographic and commodity diversity standards designed to further minimize risk. These various standards will be objectively formulated under a process external to the banks, reviewed by Congress, and monitored by Farmer Mac. A subordinated interest in a pool of such loans will have substantial protection by virtue of the credit quality standards imposed on the entire pool.

2) As loans in a pool season, the level of loss potential in the subordinate interest will diminish. This is comparable to residential mortgage pools where value is created with the reduction of risk associated with seasoned pools.

Kidder, Peabody & Co.
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Finally, it is important to note that the nation's agricultural industry has come through one of the most trying economic periods in its history. Land and commodity prices fell dramatically, with land prices falling to levels that more realistically reflect underlying economic values. This adjustment in values, particularly the recovery in commodity prices, places the implementation of Farmer Mac in one of the most promising points in the economic cycle of agriculture.

I hope that the Office of the Comptroller will take these factors as a basis for affording retained subordinated interests in Farmer Mac obligations equitable treatment under the Capital Guidelines. I would suggest an approach that would place an agricultural mortgage pool backing a Farmer Mac guaranteed obligation in the 50% risk weight category where a national bank retains a subordinate interest in the pool. This would place such mortgages in a higher risk weight category than FNMA or FHLMC pools (20%), yet provide more favored treatment than would otherwise be given, in recognition of the lower risk profile of mortgages made under Farmer Mac standards. National banks would thus be required to maintain a capital level of 4% for such pools. This would provide an adequate band of capital cushion, while affording necessary flexibility. Such an approach could be adopted for a trial period of 5 years, with subsequent evaluation and review based on actual experience.

I appreciate your interests in this matter and offer my time and efforts toward further discussions. It would be most unfortunate if our nation's farmers and ranchers are not able to realize the benefits intended by creation of Farmer Mac due to capital disincentives for national banks to fully participate.

Sincerely,

Frederick R. Medero

29-522 0 - 90 - 10

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Incorporated
Founded 1865

10 HANOVER SQUARE
NEW YORK, N.Y. 10005

Frederick R. Medero
VICE PRESIDENT

June 8, 1989

The Honorable John P. LaWare
Member - Board of Governors
Federal Reserve System
Washington, DC 20551

Dear Governor LaWare:

I just want to let you know how much I enjoyed seeing you on Tuesday and appreciate the chance we had to visit concerning the progress to date in implementing the secondary market in agricultural real estate mortgages. I hope that my presentation was successful in highlighting some of the distinguishing factors involved in the process of securitizing those mortgages using the guarantee of the Federal Agricultural Mortgage Corporation (Farmer Mac) as credit enhancement for mortgage-backed securities.

Securitization using the Farmer Mac enhancement will have a number of very positive impacts on agricultural lending. One of the most significant will be the consistent application of uniform commercial lending criteria to the underwriting and appraisal of agricultural real estate lending. The new secondary market will promote sound agricultural mortgage lending, while at the same time enabling commercial banks to compete across the maturity spectrum for quality credits, with the ability to shed related interest rate risk. I have enclosed a copy of the draft underwriting and appraisal standards recently published by Farmer Mac and which will be sent for review to the appropriate Senate and House Committees by the end of this month.

As we discussed (and addressed in my May 8, 1989 letter to Senior Deputy Comptroller J. Michael Shepherd), treatment under the risk-based capital guidelines of the Federal banking regulators is one of the most critical issues that will determine the usefulness and attractiveness of the Farmer Mac enhancement option for commercial banks.

The issue focuses on the subordinate interests retained by banks in pools or individual loans backing Farmer Mac guaranteed obligations. If it is determined by the regulators that those retained subordinate interests must be capitalized based on the outstanding principal amount of the pool or loan, it is my hope that the agencies will include those subordinate interest in the 50% risk-based category of those guidelines for the reasons outlined in my letter. For those reasons, there is sound basis for affording such pools or loans more favorable risk capital treatment than that applied to commercial real estate loans generally.

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Thank you for the chance to visit on Farmer Mac. Congress created Farmer Mac in order to improve the available of long-term credit and related service to farmers and ranchers by enabling commercial banks to be viable competitors in the area of agricultural real estate lending. I hope that this important objective can be realized.

Sincerely,

Frederick R. Medero

89-246 ENR

CRS Report for Congress

Farmer Mac and the Agricultural Secondary Market

Ralph Chite
Analyst in Agricultural Policy
Food and Agriculture Section
Environment and Natural Resources Policy Division

April 18, 1989

Congressional Research Service • The Library of Congress

Farmer Mac and the Agricultural Secondary Market

SUMMARY

The Agricultural Credit Act of 1987 authorized the formation of a secondary market for agricultural real estate loans. A number of existing secondary markets served as the model for this new market, most notably in residential housing and student loans. Many commercial lenders had long argued for the formation of an agricultural secondary market, because of the financial risk involved with committing their short-term deposits to long-term agricultural lending.

The principal players in the agricultural secondary market are loan originators, loan poolers, the Federal Agricultural Mortgage Corporation, and investors. Loan originators, or lenders, such as the Farm Credit System, commercial banks and life insurance companies make loans to agricultural borrowers for the purpose of purchasing farm real estate or a rural residence. If the loan qualifies, the originator has the option of selling the loan to a loan pooler, a certified agricultural mortgage marketing facility, which packages these loans and sells to investors securities that are backed by, or represent interests in, the pooled loans. The Federal Agricultural Mortgage Corporation (Farmer Mac) is a federally chartered, but privately funded and owned, institution responsible for guaranteeing the timely repayment of principal and interest on these mortgage-backed securities, and for the development of standards for the secondary market.

The most attractive feature of the agricultural secondary market is that both farm lenders and borrowers can potentially benefit. The lender gains liquidity and reduces interest-rate risk by receiving a return on the loan as soon as it is sold, rather than waiting up to 30 years for the periodic stream of borrower payments. The lender advantages could work their way through the credit delivery system and may allow farmers and rural borrowers to enjoy lower interest rates and a stable source of fixed-rate, long-term financing.

Critics fear that the secondary market may damage the financial recovery of the Farm Credit System, and encourage its best borrowers to flee the System for other commercial lenders. They also contend that the encouragement of farm borrowing is in conflict with current farm policy and farmer preference for less credit. Concern has also been raised that lower borrower interest rates may not materialize because of the fees charged by each of the secondary market participants.

Preliminary indications are that the potential players in the secondary market are eager to participate, but growth in the market is expected to gradually evolve. Although the market will not be operational until late 1989 or early 1990, the market could generate enough business to become viable, and offer alternative, and possibly less expensive, long-term credit to farmers and rural America.

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Farmer Mac and the Agricultural Secondary Market

Background

Although the primary purpose of the Agricultural Credit Act of 1987 was to provide Federal financial assistance to the Farm Credit System (System), the Act also authorized the formation of a secondary market for agricultural real estate loans.

The primary purpose of any secondary market is to reduce lender risk so that borrowers can have improved access to financing, and at a lower interest rate than would otherwise be the case. The agricultural secondary market is not the first of its kind. Secondary markets for residential mortgages and student loans are two of the largest secondary markets and have operated quite successfully for many years.

In general, secondary markets have been developed for certain types of loans when credit markets are perceived to be functioning inefficiently, especially if there is a shortage of funds, a poor distribution of funds to certain regions, or if the industry is subject to severe downturns in the business cycle. The residential mortgage secondary market was established in the 1930s when sources of home financing were limited.[1] More recently, the Student Loan Marketing Association (Sallie Mae) was instituted to purchase student loans to finance expenses associated with higher education.

The secondary market for agricultural real estate loans will function by allowing lenders, or originators, to sell their agricultural real estate loans to a pooler, which is an approved investment banker or security underwriter. The pooler groups the loans and sells securities to investors that are backed by the farm mortgages.

A new federally chartered but private corporation, the Federal Agricultural Mortgage Corporation, or "Farmer Mac" as it has been dubbed, will guarantee the timely repayment of interest and principal to the investor

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[1] The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) currently serve as government-sponsored but privately owned intermediaries in the residential mortgage secondary market, by actually purchasing home mortgages. The agricultural secondary market is more akin to the activities of the Government National Mortgage Association (Ginnie Mae), which strictly guarantees mortgage-backed securities, but passes on interest-rate risk to investors.

and will establish standards for the operation of the market. Farmer Mac has a line of credit with the Treasury to prevent default, but is required to tap its own reserve fund before assistance can be activated.

The Farm Credit System, a confederation of banks cooperatively owned by farmer borrowers, has long dominated the agricultural real estate lending market, primarily because of its ready access to the long-term bond market for funding its long-term loans. Commercial banks and life insurance companies are the System's largest competitors in real estate lending, but their respective market shares have lagged far behind the System for many years. Banks and insurance companies have been vocal supporters of a secondary market, viewing it as a means of enhancing their competitive position in the agricultural lending market. This renewed competition for real estate loans is expected to provide farmers with more affordable long-term credit. Throughout the debate of the Agricultural Credit Act these banks and insurance companies insisted that the secondary market authorization be part of the legislation in return for their support of an assistance package to bolster their competitor, the Farm Credit System.

The Structure of the Agricultural Secondary Market

The four major players in the agricultural mortgage secondary market are 1) loan originators, 2) loan poolers, 3) the Federal Agricultural Mortgage Corporation (Farmer Mac) and 4) investors. The following sections and the accompanying flowchart in Figure 2 summarize the functions and interactions of these participants:

Loan Originators

The three largest institutional private sector originators, or lenders, to the farm sector for the purchase of real estate are the Farm Credit System ($31.1 billion outstanding on September 30, 1988 or 47 percent of the market), commercial banks ($15.35 billion, 23 percent), and life insurance companies ($9.4 billion, 14 percent).[2] (See Figure 1.) The $65.7 billion in farm real estate debt owed to all institutional lenders is down significantly from the $82 billion outstanding just five years earlier.

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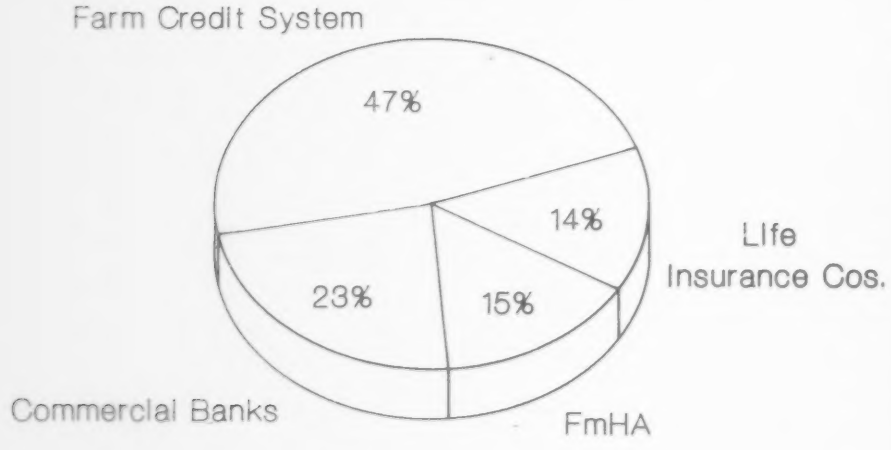
[2] The Federal government also makes direct real estate loans to farmers through the Department of Agriculture's Farmers Home Administration ($9.85 billion outstanding on September 30, 1988, or 15 percent of the market). FmHA direct farm real estate loans are not eligible for the Farmer Mac program because FmHA's mission of lender of last resort makes its loans considerably more risky than commercial loans, and would significantly increase the riskiness of the secondary market. However, a separate secondary market was established by the Agricultural Credit Act of 1987 for commercial loans that are guaranteed by the FmHA.

Farm Credit System: Until the passage of the Agricultural Credit Act of 1987, the Farm Credit System made its real estate loans through its twelve Federal Land Banks (FLBs).[3] Because the vast majority of FLB loan portfolios were tied up in agricultural real estate loans, they were hit particularly hard by the recent recession in the agricultural economy. As a result of their financial problems, the FLBs saw their market share decline from a peak of 61 percent in 1982 to 47 percent in 1988, as many borrowers feared the loss of their invested capital and fled the System for commercial banks.

Commercial Banks: Although commercial banks were also adversely affected by the downturn in the agricultural economy, they were somewhat

Figure 1.

Agricultural Real Estate Lenders, Market Shares, Sept. 30, 1988



TOTAL = $65.7 billion

[3] The Act required the System to merge in each district the FLB and the Federal Intermediate Credit Bank (FICB), to streamline System operations and as a condition for receiving Federal financial assistance. The merger of the FLB and FICB formed a new System entity called a Farm Credit Bank, which now combines into one entity the long-term real estate lending function of the FLB with the FICB function of providing funding to Production Credit Association's to make short and intermediate term production loans. For additional details see the CRS Issue Brief "Implementation of the Agricultural Credit Act of 1987" (IB88089).

insulated from financial stress by the diversity of their total loan portfolio. However, many rural commercial banks are heavily dependent on a healthy agricultural sector. Thus, some of these banks failed during the 1980s. Despite the overall trend of declining farm debt, commercial bank real estate loans outstanding rose steadily throughout the 1980s to a record high of $15.3 billion in September 1988. Even though commercial bank market share doubled from 10.7 percent in 1982 to 21.7 percent at the end of 1987, its market share is still less than one-half that of the Farm Credit System.

Life Insurance Companies: Life insurance companies have a long history of involvement in agricultural real estate lending. However, in recent years, their exposure in the farm loan market has been reduced. Insurance company farm loans peaked at $13 billion or 18 percent of the market in 1980, but steadily declined to $9.4 billion or a 14 percent market share in 1988. Premiums paid by individuals on life insurance policies are the major source of investment funds for insurance companies. Because these funds are usually invested for the long-term, farm mortgages represent a reasonable matching of maturities.

Loan Poolers

A pooler is responsible for purchasing qualifying agricultural loans from loan originators, grouping these loans into a pool, and selling securities that are backed by these pooled mortgages. Generally, a pooler can be any investment bank or security underwriter, but it must be certified by Farmer Mac before operations begin. The 1987 Act dictates what types of loans qualify for pooling, but the Farmer Mac board can adopt additional pooling requirements with congressional approval.

Loan originators may also qualify as poolers, and some of the larger ones are expected to request certification. If the Farm Credit System becomes a pooler, it will likely develop a single-entity pooler for the entire System, rather than incurring duplicative costs of each district acting separately.

The Federal Agricultural Mortgage Corporation (Farmer Mac)

The Federal Agricultural Mortgage Corporation, or Farmer Mac, is a new federally chartered corporation responsible for guaranteeing the timely repayment of principal and interest to investors in the secondary market. Farmer Mac is an institution of the Farm Credit System, but the rest of the System and Farmer Mac will not share any liability in common. Although Farmer Mac is not a government institution, it will have access to a $1.5 billion line of credit with the Treasury that can be activated only after originator/pooler and Farmer Mac reserves are exhausted. A later section of this report details more fully the operations of Farmer Mac.

Investors

Investors are the ultimate source of liquidity for the secondary market by virtue of their purchase of the Farmer Mac-guaranteed securities. Anyone is eligible to be an investor in the agricultural secondary market, although financial institutions are expected to be the largest participants. A number of lending institutions have the capability of playing the three roles of lender, pooler and investor, by originating a loan, purchasing other loans and pooling them with that loan and holding securities backed by those mortgages in their own investment portfolios.

The Farmer Mac Board

The Agricultural Credit Act established a nine-member, Presidentially-appointed interim board of directors of Farmer Mac whose primary purpose was to raise the initial capital for the Corporation. The interim board completed its initial offering in November 1988 by selling more than $20 million in capital stock, approximately one-half to the Farm Credit System and the other half to other commercial lenders. This stock gives a purchasing institution the right to participate in the secondary market as an originator or a pooler, providing the institution meets the minimum standards established by the Act and subsequent standards determined by the Farmer Mac board.

The Act required that a permanent board of directors replace the interim board after the initial stock offering was completed. The interim board was replaced by a permanent board in March 1989 at the first meeting of Farmer Mac stockholders. The permanent board consists of 15 members: five Presidential appointees, five members elected by Farm Credit System stockholders, and five members elected by stockholders from other commercial lending institutions.

The Act empowers the Farmer Mac board with three primary functions: 1) develop underwriting standards that flesh out the minimum standards for loans that qualify for sale in the secondary market (outlined below), 2) determine the eligibility requirements for poolers, and 3) guarantee the timely repayment of principal and interest to the investors in the agricultural secondary market.

How the Secondary Market Operates

The following sections and the accompanying flowchart (Figure 2) describe a typical transaction in the Farmer Mac secondary market and the minimum standards required by the Agricultural Credit Act:

1) Loans Are Made To Borrowers: The first step in the secondary market is the making of loans by commercial lenders to qualifying borrowers.

Only loans that are secured by agricultural real estate qualify in the Farmer Mac secondary market. Qualifying agricultural real estate is defined as not only land or buildings that are used in the production of agricultural commodities, but also includes a principal residence with a purchase price under $100,000 (adjusted for inflation) in any community with a population under 2,500. After a qualifying loan is made, the originator can sell the loan to a certified pooler.

2) Poolers Package Loans: Once the loans are sold by the originators, the pooler can then begin grouping these loans into pools. In addition to the requirement that pooled loans be strictly agricultural real estate loans, the Agricultural Credit Act also set minimum criteria for qualified pooled loans. The minimum criteria include the following:

- The amount of an individual loan cannot exceed 80 percent of the appraised value of the real estate.

- The borrower must demonstrate the financial capacity to make timely payments on the loan.

- For farm real estate loans, the borrower must prove that he is actively engaged in agricultural production and intends to continue farming on the land after the loan is made. This condition is intended to minimize speculation in agricultural real estate by non-agricultural investors.

- Farm Credit System borrowers must waive borrower rights before a System loan can be pooled. The Agricultural Credit Act requires System institutions to restructure a severely delinquent loan if the cost of restructuring is less than the cost of foreclosure, among other specific borrower rights. A loan with borrower rights attached would likely be viewed by investors as more risky; therefore, this requirement was adopted.

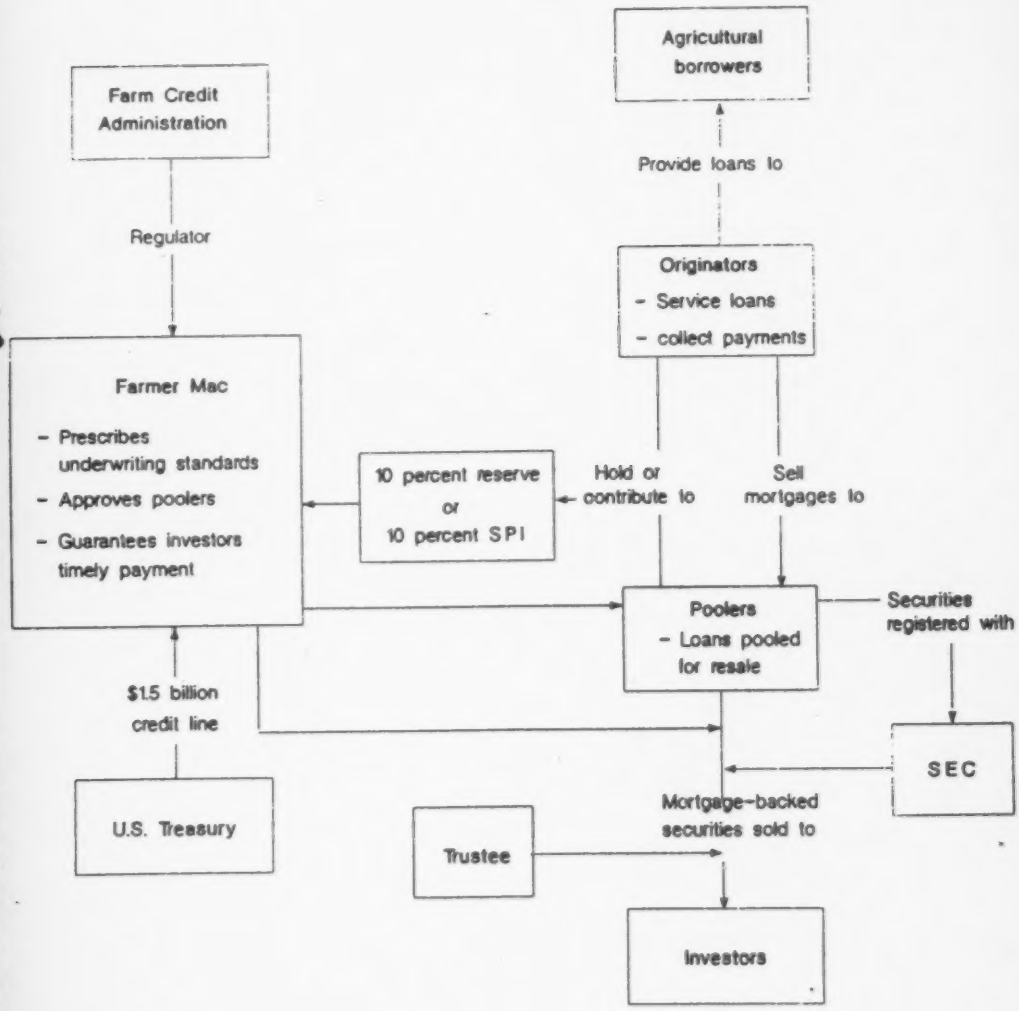
The Act also requires several standards governing the diversity of individual loan pools, in order to minimize investor risk:

- Pooled loans for the purchase of farm real estate must be representative of a wide range of commodities from a wide geographic distribution. In other words, no pool should be too heavily laden with loans to any one commodity-producer group or to the same region of the Nation, in case that particular commodity or region experiences an economic downturn.

- Individual loans in the pool should be a wide spectrum of principal amounts.

Figure 2.

Structure of the Secondary Market for Farm Mortgages



SPI = Subordinated participation interest
SEC = Securities and Exchange Commission

Source: USDA, Economic Research Service, "Prospects for a Secondary Market in Farm Mortgages", AER 603. December 1988

- An individual loan cannot exceed 3.5 percent of the aggregate amount of the pool, and each pool must consist of at least 50 loans. No loans in the pool can be to related borrowers.

3) A Reserve Is Established: At the same time that the pool is being formed, the pooler, with or without the assistance of the originator, must set up a reserve equal to at least 10 percent of the principal on each loan to be pooled. The purpose of the reserve is to require poolers and originators to share some of the risk in making a loan and to minimize investor risk and government exposure.

Reserves can be held in two forms: 1) the cash equivalent of 10 percent of the loan to be pooled, held in either cash or Treasury securities or 2) a subordinating participation interest (SPI).

An SPI allows the pooler and/or the originator to meet the required reserve by retaining 10 percent of the loan amount, rather than holding the reserve in cash or securities. To illustrate, on a $100,000 loan to be pooled, the originator and pooler have their choice of holding $10,000 in cash or securities, or they can withhold $10,000 of the loan (and assume all risk on that portion) and sell the remaining $90,000 in the secondary market.

Although the originator is selling the loan to the pooler, the originator can retain the servicing of the loan and earn fee income from the pooler for this service.

4) Farmer Mac Guarantees the Securities: The Agricultural Credit Act empowers Farmer Mac to guarantee the timely repayment of principal and interest on the securities in the agricultural secondary market. Because Farmer Mac is not a government institution, this pledge does not represent an explicit Federal government guarantee. Farmer Mac, however, does have a $1.5 billion line of credit with the U.S. Treasury in the event that the secondary market cannot make timely payments of principal or interest. Before these funds can be accessed, Farmer Mac must first exhaust the following resources:

- the reserve established by the poolers and originators backing up the securities issued and then, if necessary,

- a separate capital reserve established by Farmer Mac. Farmer Mac has the authority to charge a fee of up to 0.5 percent of the outstanding principal when a pool is established, annual pool fees of up to 0.5 percent, and special administrative fees. The Farmer Mac board must establish a segregated capital reserve account as a cushion against losses, using a portion of the proceeds from these fees.

Although the Farmer Mac capital stock sold to participating institutions is technically at-risk, the Act does not require that this stock be tapped before the Treasury line of credit.

5) Investors Purchase Securities: After all of the criteria are met, poolers can sell Farmer Mac-guaranteed, mortgage-backed securities to investors. Although the Farmer Mac guarantee insulates investors from the risk of not being repaid, investors still must bear the risk of future fluctuations in interest rates and the potential for borrower prepayment before maturity. Because a secondary market investment is not totally risk-free, investors are expected to demand a premium in the vicinity of 1.5 percentage points over the yield on a comparable Treasury security. In other words, if investors could earn 9 percent interest on a risk-free 10-year Treasury note, they may require a 10.5 percent yield on a Farmer Mac security.

Potential Benefits of an Agricultural Secondary Market

The most attractive feature of an agricultural secondary market is its potential to benefit both agricultural lenders and their farmer borrowers. Although time will be the greatest test of whether these benefits will actually accrue to lenders and borrowers, proponents of the secondary market cite several advantages to the secondary market.

Lender Advantages

Increased Liquidity, Reduced Risk: A lender participating in the secondary market can make a long-term, farm real estate loan, sell that loan to a pooler, and use these funds to make new loans, rather than waiting up to 30 years to receive the periodic stream of interest and principal payments from the borrower. At the same time, the lender can be insulated from the interest-rate risk associated with committing funds to a long-term loan by shifting that risk to the secondary market.

Because liquidity has been a major obstacle to commercial bank participation in the farm real estate market, commercial banks are expected to benefit the most from the enhanced liquidity that the secondary market offers. Banks have been hesitant to devote a large portion of their loanable funds to farm real estate because of the potential mismatch of maturities of their assets and liabilities: most of their liabilities are in the form of short-term deposits while farm real estate lending requires a long-term commitment of funds.

Like commercial banks, insurance companies welcome the liquidity that the secondary market offers, which could entice some insurance companies to increase their lending activity in the farm real estate market and may encourage other companies to enter the market for the first time. Although life insurance companies have stable access to long-term funds through the

premiums they collect from investors, they view the secondary market as an ideal way of managing their portfolios in a volatile interest-rate environment.

The Farm Credit System can also benefit from improved liquidity, but to a lesser extent than the other commercial lenders. Some critics of the secondary market stated that there was no need for a secondary market because in their view the Farm Credit System already serves as one by virtue of its borrowing long-term funds in the same agency bond market as Freddie Mac and Fannie Mae, and lending these funds directly to farmers.

Improved Rural Bank Competitiveness: The secondary market could allow small rural banks to expand their source of funds beyond the narrow scope of their limited local deposit base. Because of their isolation from national markets, rural banks depend to a large extent on customer deposits as a source of loanable funds, and as a result, they tend to pay a higher price for funds than large money center banks. By having the opportunity to sell their farm real estate loans in the secondary market, rural banks will be able to compete in the same marketplace as large banks for their funding base, which could help them lower their overall cost of funds. In addition, bankers anticipate that they will be able to compete more effectively with the Farm Credit System as a one-stop source of funds.

Fee Income: All lenders participating in the agricultural secondary market will have the opportunity to enhance their earnings by charging the pooler a fee for their continued servicing of the loan after it is sold. This will enable participating lenders to diversify their income at a time when many banks are seeking alternative sources of income.

Borrower Advantages

All of the above advantages that are expected to accrue to lenders could work their way through the credit delivery system and translate into better credit terms for farmer and rural borrowers. Lender potential for reduced risk, increased liquidity, diversified funding sources and enhanced income would allow the borrower to reap the benefits of more competitive interest rates and a stable source of fixed-rate, long-term financing.

Fixed Rates: Volatile interest rates in the 1970s and early 1980s made it difficult for farmers and lenders alike to make business decisions, because of the uncertainty of the direction of interest rates. Many lenders resorted to adjustable rate mortgages as a means of passing on some of the risk associated with making a long-term loan to the borrower. As market rates rose in the early 1980s, debt servicing expenses began to account for a growing percentage of farm production expenses. Coupled with reduced collateral values, high interest rates led to insolvency of many farm operations. Although rates have moderated in recent years, many farmers with adjustable rate mortgages are still threatened by the specter of renewed inflation and high interest rates. The framers of Farmer Mac project that the

secondary market will allow lenders to make fixed rate loans and shift the interest-rate risk from borrowers and lenders to investors.

Improved Access to Credit: Historically, the farm sector has been extremely vulnerable to credit market conditions, because of the sector's heavy reliance of credit as an input to production. The secondary market is expected to help insulate the farm real estate market from local or national credit conditions by providing lenders with stable access to funds. This could allow farmers to finance expansion of their operations, when credit availability would traditionally be tight.

However, many analysts contend that the current problem is not a credit shortage, but rather a lack of creditworthiness on the part of many potential borrowers because of stricter lending requirements imposed by commercial lenders.

Lower Rates: Because commercial banks and life insurance companies are expected to heighten their lending activity in the farm real estate market, the added competition could help reduce the farmer's cost of borrowing and improve and increase the services that lenders will make available to their prospective borrowers.

Potential Problems with the Secondary Market

Throughout the debate of the Agricultural Credit Act of 1987, the Reagan Administration was strongly opposed to the formation of an agricultural secondary market. In the early stages, the Farm Credit System also voiced concern over the effect the market would have on its competitive position. The following are some of the drawbacks of a secondary market as viewed by its opponents.

Market Distortions: Proponents of a secondary market contend that if the loan underwriting standards are stringent enough, the benefits of the secondary market can be achieved at little or no cost to the taxpayer. Opponents counter that even if none of the $1.5 billion line of credit with the Treasury is tapped, certain implicit costs still exist. A primary hidden cost is that funds will be diverted from other sectors of the economy to the agricultural sector. Farm borrower interest rates are expected to be lower under a secondary market, encouraging investment in agricultural production. Because a finite amount of credit is available in the national economy, (based on the savings rate of the nation), critics wonder whether some other sector of the economy will experience a relative shortage of investment capital as funds are diverted to agriculture.

FCS Already Is A Secondary Market: Critics of a secondary market argue that there is no need for an agricultural secondary market since the Farm Credit System already serves that purpose. In effect, the System acts as both an originator and a pooler by issuing securities in the agency bond market and making direct loans through its lending institutions. When

Congress chartered the System, its intention was to provide a stable source of credit to the agricultural sector, in both times of prosperity and downturns in the economy. Skeptics contend that the secondary market duplicates many of the functions that can already be served by the Farm Credit System. They also fear that an expansion of these secondary market privileges to other commercial lenders may damage the financial recovery of the System, encouraging the System's best borrowers to pursue other sources of credit.

Investor Risk: Even though investors are protected from borrower default by Farmer Mac, they still must bear interest-rate risk and the risk associated with the prepayment of pooled loans by borrowers. Because the securities that the investors are purchasing are backed by mortgages, the flow of funds to the investor is dependent on the scheduled payment of principal and interest on the mortgage by the borrower. When market interest rates decline significantly, borrowers may seek to refinance their mortgage at the lower interest rate. The original mortgage is prepaid from the proceeds of the new mortgage, and investors receive their pro rata share of the proceeds. The investor is then faced with having to re-invest these funds at what may be a significantly lower interest rate than when the original investment was made in the secondary market. Conversely, when interest rates are rising, borrowers are less likely to refinance their mortgages, but reinvestment opportunities offer investors a higher return.

Prepayment risk and interest rate volatility, therefore, could make investment in the secondary market considerably less attractive than Treasury securities and other "safe" investments. To help compensate for this risk, lenders are expected to offer fixed rates with a prepayment penalty. In the absence of a prepayment penalty, investors may require a higher premium for the added risk.

Reduced Credit Needs: While proponents boast that the secondary market will provide expanded sources of credit for farmers, critics say that more credit is the last thing that the farm sector needs. The recent farm financial crisis was an outgrowth of overborrowing in the 1970s, with the expectation that inflation and farmland values would continue their steep rise. Lenders made the mistake of advancing credit based on the premise of continued inflation rather than on the cashflow capability of their borrowers. This gamble failed in the 1980s when higher interest rates, lower inflation and smaller export markets led to the collapse of the farm real estate market, causing some borrowers to default on their farm loans. Some surviving farmers are still reeling from the crisis and have adopted cost-cutting measures that require less credit instead of more. Moreover, many farmers are skeptical about expanding their operations and purchasing more land based on their recent credit problems.

Lower Rates May Not Materialize: Some critics of the secondary market contend that by the time each of the participants in the market is compensated for their participation, interest rates to farm and rural borrowers may be no lower than in the absence of a secondary market. Some analysts

estimate that the Farmer Mac guarantee fee, the originator's initial and servicing fee, the profit to the pooler, and the risk premium paid to investors could add approximately 3 percentage points to whatever the yield is on a comparable long-term Treasury note. To illustrate, if a 10-year Treasury note is priced at 9 percent, a Farmer Mac security would sell for 12 percent after the 3 percentage point spread is added, which may not be any more competitive than prevailing market lending rates

Public Policy Conflicts: Critics contend that a secondary market may make credit more readily available and thus encourage overproduction. At the same time, current long-term farm policy legislation provides for the gradual reduction in government price and income supports in order to reduce the Federal budget costs. Critics contend that the secondary market may stimulate agricultural production and depress commodity prices, damaging initiatives to wean agriculture from government programs.

Conclusion

The success of the secondary market hinges considerably on the amount of volume the market will generate. The total amount of Farmer Mac guarantees is limited by law to 2 percent of outstanding farm real estate loans in 1988, an additional 4 percent in 1989, and an additional 8 percent in 1990, in order that the Farm Credit System is not damaged by the competition and by borrower flight to other lenders. Although fears still persist that System viability may be damaged by the market, ironically, the success of the secondary market hinges on the participation of the System. Because the System represents such a large percentage of agricultural real estate debt, the market would probably not generate enough volume to operate efficiently, without System participation.

Preliminary indications are that each of the potential players in the secondary market are poised for participation. Lenders gave an enthusiastic response to the initial stock offering of $20 million, indicating the potential for high lender participation rates. Farm Credit System opposition to the market has waned and System leaders have indicated that the System will participate in the market and will even form its own pooler. Farmer Mac is expected to set relatively stringent underwriting standards for pooled loans minimizing the risks associated with the market. Farm and rural borrowers are interested in the new competition for their business and look forward to the potential for lower rates and improved services that the secondary market offers. Preliminary investor perception is that a Farmer Mac investment will be relatively secure and marketable.

The agricultural secondary market will not be operational until late 1989 or early 1990. All indications are that the market will gradually evolve and will not account for a large portion of the agricultural real estate market in its early years. The market will be devoting much of its attention to the formation of loan pools with high quality loans that will capture the attention

of investors. Over time, the market could generate enough business to become viable and offer alternative, and possibly less expensive, long-term credit to farmers and rural America.

Appendix: Farmer Mac Chronology

Jan. 6, 1988	Agricultural Credit Act of 1987 is enacted containing provision for the creation of Farmer Mac.
June 16, 1988	Presidentially-appointed, nine-member interim board of Farmer Mac is sworn in. Primary purpose of board is to issue a minimum initial stock offering of $20 million to potential lender and pooler participants.
Late June 1988	President nominates five appointees to the permanent board of Farmer Mac.
September 1988	Senate Agriculture Committee clears four of the five nominees to the permanent board.
October 1988	Interim board passes final approval on a prospectus for the Farmer Mac stock sale.
December 1988	Farmer Mac completes its initial stock offering, selling shares worth $10 million to Farm Credit System institutions and another $10 million to other commercial financial institutions.
March 1989	First meeting of Farmer Mac stockholders. Ten board members representing the Farm Credit System and commercial lenders are elected by stockholders and sworn in at meeting. Permanent board assumes its responsibilities from interim board.

Projected Dates

April 1989	Farmer Mac task forces are expected to submit recommendations to the Farmer Mac Board on underwriting and pooler certification standards.
May 1989	Farmer Mac will hold public hearings on refinement of these standards.
June 1989	Farmer Mac will likely submit the standards to Congress for approval. Deadline for submission is 120 days after the first Farmer Mac meeting, which was held March 2, 1989.) Congress has 90 days to act on the standards.
Late 1989	First loan pools are expected to be formed.
Early 1990	First issuance of securities to investors, making the agricultural real estate secondary market operational.

THE FARM CREDIT COUNCIL
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Written Statement
by

Pat Pinkham

Chairman
Farm Credit System
Certified Facility Organizing Board

Before

The Honorable Glenn English, Chairman
Subcommittee on Conservation, Credit & Rural Development
House Committee on Agriculture

September 27, 1989

Mr. Chairman and Members of the Committee.

We are submitting this written statement today on behalf of the Farm Credit System Banks that are in the process of establishing a certified facility within the Farm Credit System. We will soon be requesting a charter for this certified facility from the Farm Credit Administration. We appreciate this opportunity to comment on the proposed underwriting and pooler certification standards of Farmer Mac and the potential impact on Farmer Mac's ultimate success.

Farmer Mac is important to the Farm Credit System for several reasons. It allows us to offer a wider range of products without absorbing the risk incurred with long-term, fixed-rate loans. It will help System institutions serve more farmers without putting additional pressure on capital. Further, it provides a new asset-liability management tool that the System has not had available.

The Farm Credit System's objective has been and continues to be to make the fullest use of Farmer Mac. We intend to be a major participant and to use this new secondary market to the benefit of farmers and ranchers. The System strongly supports whatever helps farmers and ranchers obtain a more competitive interest rate. We intend for our pooling operation to be in a position to compete aggressively to buy loans from System and non-System lenders as soon as Farmer Mac is operational.

Our optimism with regard to Farmer Mac is tempered by two principal concerns:

o That the Farmer Mac Credit Underwriting, Loan Repayment, Security Appraisal, and Loan Diversification Standards must not be loosened as a result of political pressure. We do not believe that Congress intended for Farmer Mac to become a dumping ground for poor credit. We believe that the existing standards are set to attract a broad range of borrowers and we urge that they be

implemented as drafted.

o That the proposed capital standard would allow institutions **not** regulated by one of the financial institution regulators to operate with considerably less capital than financial institutions like commercial banks and the institutions of the Farm Credit System.

This issue arises from the Eligibility Standards for Certified Facilities. Eligibility criteria No. 6 states that the institution "must have a minimum of $2 million in capital conforming to Farmer Mac standards for admissible capital, and meet or exceed the capital standards established by the institution's regulatory agency or agencies."

It is our belief that this capital standard could "give the market" to high-risk poolers and eliminate a very important segment of potential poolers--that is, commercial banks and institutions of the Farm Credit System, which could be forced to comply with much higher capital requirements. Criteria No. 6 is entirely inadequate when viewed in the light of the wide variety of entities that have purchased enough stock to become a certified facility. Some will be regulated--for capital purposes--by banking regulators, some possibly by the Securities and Exchange Commission, some possibly by state Insurance Commissioners, some by the Farm Credit Administration and still others could be entirely unregulated. In fact, if all the entities that purchased sufficient stock to become a pooler do so, those entities would be regulated by no fewer than 13 different state and Federal regulators. The differences in capital requirements among regulators, coupled with the fact that some of those regulators do not have a working knowledge of the capital requirements appropriate for loan pooling operations, create the potential for a significant and entirely unnecessary risk to the viability of the agricultural secondary market and ultimately the future of Farmer Mac. Section 8.5(a)(3) of the 1987 Act expressly states that "The [certified facility certification] standards...shall not discriminate between or against Farm Credit System and non-Farm Credit System applicants." Relying on "capital standards established by [each] institution's regulatory agency or agencies" will unquestionably discriminate against not only Farm Credit System poolers, but also against commercial bank poolers. Collectively, these two groups represent two-thirds of the potential poolers.

We are not suggesting that Farmer Mac establish itself as another layer of regulation; only that Farmer Mac adopt the most conservative regulator's capital and liquidity standards for all poolers and make those standards a requirement for maintaining Farmer Mac Pooler Certification. To do otherwise is likely to make commercial banks and Farm Credit System institutions non-viable as poolers and reduce significantly the number of poolers in the market. We think it is in the best interests of Farmer Mac as well as farmers and lenders that there be adequate pooler competition for loans.

One last comment on the capital issue. At present the draft standards do not address how capital is to be held. It is our position that the source of pooler capital should be in cash or cash equivalent until the cash is used to purchase loans,

otherwise capital should remain as a liquid asset.

Having summarized our position on these two important issues, I would now like to provide the Committee with some additional background.

Underwriting, Loan Repayment, Security Appraisal and Loan Diversification Standards

The proposed standards represent a good foundation upon which Farmer Mac can begin operations. Time and experience may later result in the need for minor changes, but until we have the benefit of experience, Farmer Mac or the Congress would be making those changes without adequate justification. In the current form we believe that the standards are sufficient to ensure that investors in Farmer Mac securities (both senior and subordinated) believe that the underlying agricultural loans are of sound credit quality. This is vital since investors will not know the borrowers, or anything about their financial condition. Their only source of assurance will be the credit, repayment and appraisal standards required by Farmer Mac. The government guarantee is a double-edged sword. It provides comfort, but a call on the guarantee would cause irreparable harm to the long-term success of Farmer Mac.

The more critical issue with regard to keeping Farmer Mac's standards strong relates to the reserve or retained subordinated interest requirement. The holder of the subordinated interest must bear the risk of at least the first ten percent of all losses on each loan pool. Whoever holds that interest will expect to be compensated for the associated risks. If standards were "loosened", more losses could result and subordinated interest holders will justifiably demand compensation to cover the risk of such losses. This compensation comes in the form of higher interest rates to the farmers whom we are seeking to serve. The premium to cover risk will be built into the interest rate on all Farmer Mac loans. Ultimately, the farmers that take Farmer Mac loans will pay for losses incurred by Farmer Mac. As I said earlier, Farmer Mac should not be a "dumping ground" for substandard and/or high risk loans. Were it to happen, all farmers will pay the price through higher interest rates.

Pooler Capitalization

As we have already said, the present pooler capital standards would very likely give the pooling market to unregulated, thinly-capitalized entities and shut the Farm Credit System and commercial bankers out of that market altogether, in direct violation of the anti-discrimination mandate of Section 8.5(a)(3) of the Farm Credit Act.

Our concerns about pooler capital stem not only from a desire to have a fair chance to compete in this new market, but also from more fundamental concerns about the safety and viability of this market. A certified facility may, as a result of its decisions regarding pipeline and warehouse risk management strategies, pricing programs, retention of subordinated pool risk and other operating practices, significantly increase its risk position and, therefore, its requirements for capital. In addition, pooler capital requirements will grow over time as business

volume and retained subordinated interests grow. (Subordinated interest capital requirements are, of course, cumulative as more securities are sold.)

We also urge Farmer Mac to not focus exclusively on the statutory requirement for a minimum capital standard, but to also establish liquidity requirements that will offer protection for liquidity risks. A pooler must have the "staying power" to stay with what it starts. Poorly capitalized poolers could be in the market one day and out the next. We have estimated total capital required after only two years of operation could be as much as $50 million.

Poolers can take on the look and risks of a sizable financial institution and if an inadequately capitalized pooler is unable to meet its obligations and fails, that failure will adversely impact all other poolers and Farmer Mac.

Even though Farmer Mac can rely on the subordinated structure of the security as a first line of defense against financial losses, the consequences to Farmer Mac and other poolers, if one or more poolers fail because of losses on the subordinated interest or for other reasons, could lead to very serious questions about the long-term future of Farmer Mac guaranteed securities and result in less competitive interest rates for farmers. Furthermore, if poolers that are less conservatively regulated with regard to capital and liquidity leverage themselves into unsound risk positions and fail, Farmer Mac will be forced to step into the failed poolers' shoes and may incur losses which again threaten its existence.

The success of Farmer Mac will, in large measure, depend on the success of Farmer Mac poolers. It is essential that pooler eligibility standards give maximum assurance that poolers can perform their responsibilities on a safe, sound and responsible basis. In its early years, Farmer Mac will be very visible. It will be closely watched by Congress, FCA, GAO, the public, Farmer Mac stockholders, potential investors, and more importantly by those it's intended to serve--farmers. Pooler standards are a critical step in assuring investors and other observers that Farmer Mac securities, both senior and subordinated, are a sound investment.

Conclusion

We want to conclude our statement by offering our congratulations to Chairman Jack Dahl, along with all other board members, for their leadership and dedication. Farmer Mac has made significant progress in a short time. The Farm Credit System has been in the long term agricultural real estate lending business for over 70 years. We understand, perhaps better than anyone, the challenges that Farmer Mac faces in developing a program that satisfies its many constituencies. We also understand how difficult it is to develop standards that adequately fit all areas of the country and all agricultural enterprises. It is a tough job and it cannot be expected to be done overnight.

We also want to express our appreciation to this Committee for its continuing involvement in the implementation of the Agricultural Credit Act of 1987, and notably the development of

Farmer Mac. We believe that forums such as these enhance understanding of the issues and promote realistic expectations about how much can be done in what time period.

In the final analysis, we are all interested in one thing -- a sound program that benefits farmers. If the program gets tied up in knots for one reason or another, farmers lose. If Farmer Mac is forced to move too fast in some areas, Farmer Mac may start quick but later fail, and farmers will still lose. The failure of Farmer Mac is not an acceptable alternative to us.

Thank you for allowing us to submit this statement.

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HONORABLE VIRGINIA SMITH
STATEMENT BEFORE THE HOUSE AGRICULTURE SUBCOMMITTEE ON
CONSERVATION, CREDIT, AND RURAL DEVELOPMENT

September 27, 1989

Thank you Mr. Chairman, Mr. Coleman, and members of the subcommittee for allowing me the opportunity to testify today on the creation and implementation of the Federal Agricultural Mortgage Corporation (FAMC), more commonly known as Farmer Mac.

Like all of you, I have a great interest in and strong support for the creation of a secondary market for rural real estate loans.

Like many others, I cling to the hope that Farmer Mac can be up and running as early as possible in 1990, fulfilling its mission and our expectations in the agricultural economy.

But the conventional wisdom is that continuing bureaucratic delay and disagreement are threatening the timely implementation of this new secondary market.

The importance of these hearings includes the possibility that they will crystallize consensus and inspire appropriate, effective action. I commend you for the committee's diligence and urge it to continue to hold appropriate oversight hearings like this.

Today as the subcommittee meets to review the loan standards and regulations developed by the Farmer Mac Board, I wish to offer the concerns and suggestions I have heard from my constituents and various farm organizations as the implementation of Farmer Mac moves ahead.

They say that the following underwriting standards merit additional consideration by the subcommittee:

- o Loan geographical and crop diversity requirements.
- o Agricultural real estate appraisals.
- o Risk-associated mandated reserves.
- o Security Exchange Commission (SEC) registration and disclosure.
- o Disagreements involving rural housing provisions.
- o Loan eligibility standards.
- o Lenders' capital requirements.
- o Flexibility with appropriate restrictions.

In Nebraska, the financial community is divided on the need for the stringent loan eligibility requirements put forward by the Board.

While I am aware of the differing positions held by the various national organizations, I know also that division exists within their own memberships.

In particular, the subcommittee should focus on the importance of creating an encouraging climate for investors interested in Farmer Mac. The standards put forward by the Farmer Mac Board are directly tied to the numbers of default and payment schedules an investor might expect.

The proposed standards limit pooling to higher quality loans, thus increasing the caliber of the possible investment. The Board offered this proposal to reassure investors, and they have accepted it.

Some financial groups say these requirements are unreasonably prohibitive. Yet, federal regulators argued the rules are not restrictive enough.

Recently, Robert L. Clark, the Comptroller of the Currency, announced an additional requirement that would result in an even

greater burden upon smaller banks participating in Farmer Mac.

This policy would require substantially higher capital adequacy and legal lending limits for Farmer Mac participant banks when compared to banks involved in other government-sponsored secondary markets, such as Fannie Mae and Freddy Mac.

Smaller, community banks argue this requirement would prevent them from financing the long-term credit needs of farmers and ranchers.

The Farmer Mac Board has taken a position contrary to the Comptroller's position and discussions are ongoing.

Turning now to criticisms of Farm Mac proposals by the Government Accounting Office (GAO), I agree we must be particularly concerned about such difficult issues as pooling capabilities and the consistency of financial information.

One GAO point of particular concern to Nebraskans calls for greater restriction and less flexibility in all regulations put forward by the Farmer Mac Board.

I strongly disagree.

The dynamic, versatile approach recommended by the Board allows the secondary market standards to adapt to unpredictable situations. The Board members found that rigid definitions and specifics prevented appropriate response to varying circumstances.

Mr. Chairman, a balanced, workable consensus still is possible without the misery of congressional micromanagement. The technical capabilities necessary to develop a solution are found on the Farmer Mac Board and within the federal agencies.

The facts are that failure of private sector and federal and

state agencies to agree on these and other elements of Farmer Mac's future operations raises the question of whether Farmer Mac ever will become an operational reality.

Congress must not let Farmer Mac be a flop.

If the industry and governmental agencies fail to agree, then I think we as members of Congress must pick up the ball. We must make the necessary decisions.

American agriculture needs Farmer Mac. We cannot afford to let Farmer Mac falter, fail, and fade away.

As I see it, the administrative process of putting flesh on the legislative framework we provided is bogged down and that Farmer Mac is not necessarily suffering from any terminal illness.

I say that the difficulties being faced today are more concerns of appropriate regulation and requirements--not necessarily for lack of more legislative action.

Nebraska's organizations, lenders, and my constituents are generally pleased with the design and results of the Agricultural Credit Act of 1987.

After the financial chaos of the early eighties--grain embargoes, unstable fiscal policies, and an overvalued dollar--a stabilization across rural America has occurred now in the late-eighties.

This easing of financial tension has lessened the pleas for assistance from the Federal Government. Nevertheless, we must press vigorously for getting Farmer Mac on the track against future roller-coaster economic stress that undoubtedly will continue to plague the agricultural economy.

I am pleased that this subcommittee has provided this hearing, following one held by the House Banking Subcommittee on Financial Institution Supervision, Regulation, and Insurance earlier this month.

Both meetings will help demonstrate congressional concern about industry and agency failures to get on with putting this vital legislation into effect.

Finally, I wish to commend two Nebraskans for the special efforts they have made throughout the development of Farmer Mac. Mr. Tom Olson of Lisco, Nebraska, is a current member of the Farmer Mac Board and former president of the Independent Bankers Association of America; and Mr. Kelly Holthus of York, Nebraska, is the President-elect of the American Bankers Association.

Both of these individuals have sacrificed considerable time and attention throughout the development of Farmer Mac.

In addition, I recognize the positive impact the efforts of Chairman Jack Dahl and the other competent members of the Farmer Mac Board have had upon agriculture and its communities.

I offer my personal thanks for all your hard work.

Mr. Chairman, now is the time to make certain that Farmer Mac will work safely and effectively for our constituents. I appreciate having the opportunity to testify today on this very important issue.

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